

INSIDER TRADING: THE "POSSESSION VERSUS USE" DEBATE

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INTRODUCTION

Addressing a question that has long been a subject of debate among legal commentators,¹ the Ninth and Eleventh Circuits recently held that "knowing possession" is not sufficient to impose insider trading liability under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.² At issue in this debate is whether section 10(b) and Rule 10b-5 require a causal connection between the material, nonpublic information and the insider's trading—that is, a showing that the insider actually *used* the information—or whether knowing possession of such information at the time of the trade is sufficient for liability to attach.

Few courts have addressed this issue directly.³ Indeed, in many cases it has not been necessary for the courts to address the issue: often it is clear that the insider used the information.⁴ As Allan Horwich

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¹ See Allan Horwich, "Use Test" in *Insider Trading Cases Update*, CORP. LEGAL TIMES, Nov. 1998, at 61 ("In the past year two Courts of Appeal have resolved a question which had long been the subject of debate among commentators . . .").

² See *United States v. Smith*, 155 F.3d 1051, 1069 (9th Cir. 1998), *cert. denied*, 119 S. Ct. 804 (1999) ("[W]e reject the government's proffered 'knowing possession' standard for insider trading violations . . ."); *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998) ("[M]ere knowing possession . . . is not a per se violation.").

³ See *Adler*, 137 F.3d at 1334 ("Surprisingly, few courts have directly addressed whether § 10(b) [and] Rule 10b-5 . . . require a causal connection between the material nonpublic information and the insider's trading or whether knowing possession of material nonpublic information while trading is sufficient for liability."). A few courts have addressed the issue indirectly or in dicta. See, e.g., *United States v. Teicher*, 987 F.2d 112, 120-21 (2d Cir. 1993) (advocating a knowing possession standard but asserting that it was unnecessary to rule on the issue); *Investors Management Co.*, 44 S.E.C. 633, 644 (1971) (appearing to advocate a "use" standard).

⁴ See DONALD C. LANGEVOORT, *INSIDER TRADING: REGULATION, ENFORCEMENT, AND PREVENTION* § 3.04, at 3-22 (1999) ("In the typical case, there is no question that the insider traded in order to take advantage of material nondisclosed information."); see also Harvey L. Pitt & Karl A. Groskaufmanis, *Actual Use of Inside Information at Issue*,

has noted, however, "[t]he scarcity of pertinent cases does not . . . mean that the question is merely of abstract interest. . . . [T]he issue frequently arises in counseling [corporate executives] who may obtain inside information pending completion of a transaction or in the midst of a pre-established trading program."⁵

This Comment will examine the "possession versus use" debate, assessing the arguments that have been made in support of the two sides and concluding that "knowing possession" is the more appropriate standard. Because one cannot develop a sensible rule without first understanding the rule's purpose, Part I will begin with an overview of insider trading, including the rationale underlying its prohibition. Part II will then present the "possession versus use" debate, exploring the origins of the debate, as well as the recent cases addressing the issue. Next, Part III will examine more closely the arguments advanced in support of the "use" standard. Advocates of the "use" standard have based their arguments largely on Supreme Court precedent. As discussed in Part III, however, this reliance on prior case law is misplaced because the question of "possession versus use" was not at issue in the cases relied upon. Rather than relying on prior case law, this Comment suggests that one should instead consider the reasons underlying the insider trading prohibition, as well as the difficulty of proof associated with prosecution, to determine the appropriate standard. These considerations form the basis for the arguments in support of the "knowing possession" standard. Part IV will discuss these arguments, concluding that "possession" is the more appropriate test for insider trading liability.

I. OVERVIEW OF INSIDER TRADING

"'Insider trading' is a term of art that refers to unlawful trading in securities by persons who possess material nonpublic information about the company whose shares are traded or the market for its

NAT'L L.J., June 21, 1993, at 20 ("In most insider-trading cases, . . . the distinction between 'use' and 'possession' is of limited significance.").

⁵ Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235, 1236 (1997). Horwich presents several interesting hypothetical situations in which the issue might arise. Consider, for example, an executive of a public company who, "nearing retirement, begins a regular program to liquidate her large holding of company stock in order to diversify her portfolio, instructing her broker to sell 1000 shares on the first of each month. During the program, the executive learns nonpublic negative material information about the company." *Id.* at 1235.

shares."⁶ Although the federal securities laws do not expressly proscribe insider trading, section 10(b) of the Securities Exchange Act of 1934⁷ and Rule 10b-5⁸ promulgated thereunder by the Securities and

⁶ LANGEVOORT, *supra* note 4, § 1.01, at 1-6. This definition of insider trading, of course, presupposes the answer to the "possession versus use" debate. Compare RALPH C. FERRARA ET AL., FERRARA ON INSIDER TRADING AND THE WALL § 2.01[1], at 2-2 to 2-3 (1998) (explaining that insider trading occurs "when a corporate 'insider' . . . trades the securities of the corporation *while in possession of* material, nonpublic information" (emphasis added)), with 2 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 7.4(100), at 7:101 (2d ed. 1998) ("[I]nsider trading is the *use of* . . . material nonpublic information . . . to buy securities (if the information is favorable) or sell them (if the information is unfavorable)." (emphasis added)). Unless quoting or describing the views of others, this Comment will employ "possession" language when discussing the nature of insider trading violations.

As many commentators have noted, the term "insider trading" is a misnomer. For example, liability for insider trading has not been limited to the class of persons traditionally considered "insiders." See LANGEVOORT, *supra* note 4, § 1.01, at 1-6 ("The prohibition against insider trading applies to a larger class of persons than those traditionally considered corporate insiders."); Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading*, 41 BUS. LAW. 223, 224 (1985) [hereinafter *Task Force Report*] ("The cases in which the Commission and private litigants have sought to impose liability under existing law have not been limited to insiders, at least as that term is commonly understood . . ."); see also *infra* note 12 and accompanying text (explaining that the term "insider" refers to a broader class of persons than those traditionally considered corporate insiders). Furthermore, a person may be liable for insider trading even if he did not actually trade. See *Task Force Report*, *supra*, at 224 (explaining that "not all defendants have been traders—those who 'tip' others who then trade" have also been found guilty of insider trading); see also *infra* note 13 and accompanying text (discussing tipper liability).

⁷ Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange— . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1997).

⁸ Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,
 (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

Exchange Commission ("SEC") have been interpreted as prohibiting insider trading.⁹ In interpreting these provisions, the SEC and the

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1999).

⁹ The original purpose of section 10(b) was not necessarily to prohibit insider trading. See ELIZABETH SZOCKY, *THE LAW AND INSIDER TRADING: IN SEARCH OF A LEVEL PLAYING FIELD* 5 (1993) ("Contrary to popular belief, Section 10(b) . . . which today is the most commonly used section to prosecute insider trading, was not originally designed to serve this purpose."); *id.* at 6 ("Nowhere in the legislation or in related discussions at the time is there an implication that Section 10(b) should be interpreted to include or could be applied against insider trading."). For a comprehensive discussion of the original purpose of section 10(b), see Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990). Nor was the central purpose of Rule 10b-5 to prohibit insider trading; indeed, the rule was initially drafted to prevent insiders from making fraudulent statements to shareholders about the corporation so that they could buy shares more cheaply. See Milton Freeman, Discussion at the Conference on Codification of the Federal Securities Laws (Nov. 18-19, 1966), in 22 BUS. LAW. 793, 922-23 (1967) (discussing the adoption of Rule 10b-5). In 1943, Milton Freeman, an SEC attorney, received news about a company president who was buying up shares of stock of his own company, simultaneously telling shareholders that the company was faltering, though in fact the prospects of the company were extremely favorable. See *id.* at 922 (describing a phone call in which Freeman learned that "the president of some company . . . is . . . buying up the stock of his company . . . and . . . telling [shareholders] that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled"). Attempting to address this problem, Freeman drafted Rule 10b-5. See *id.* (explaining that Rule 10b-5 "was intended to give the Commission power to deal with this problem").

Section 16(b), 15 U.S.C. § 78p(b) (1994), is the only provision that expressly proscribes trading by insiders. See, e.g., FERRARA ET AL., *supra* note 6, § 1.02[1][a], at 1-3 ("The only provision of the securities statutes that expressly regulates insider trading is Section 16(b) of the Exchange Act, which prohibits 'short swing' profits by officers, directors, and the direct or indirect beneficial owners of more than 10% of any class of equity securities." (footnote omitted)). "Short-swing" trading refers to "any purchase and sale, or any sale and purchase" within a period of less than six months. 15 U.S.C. § 78p(b). Many have asserted that section 16 was designed to prevent insider trading. See 15 U.S.C. § 78p(b) (explaining that the purpose of the provision is to "prevent[] the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer"). But section 16 imposes liability on insiders who engage in short-swing trading, regardless of whether they were in possession of material, nonpublic information at the time of the trades. And insiders can avoid liability under section 16(b)—even if they are trading while in possession of material, nonpublic information—as long as they do not enter into offsetting transactions within a period of less than six months (i.e., a sale following a purchase or a purchase following a sale). Some commentators have thus proposed alternative explanations of the purpose of section 16(b). See Karl Shumpei Okamoto, *Rereading Section 16(b) of the Securities Exchange Act*, 27 GA. L. REV. 183, 185 (1992) ("The purpose of Section 16(b) is not the deterrence of trading on non-public information. . . . Its purpose is to deter insiders from trading to artificially affect market prices—to deter insiders from sending false signals when in fact there is no inside information at all."); Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 393, 453 (1991) (asserting that the purpose of section 16 was to prevent the manipulation of corporate opportunities).

federal courts have developed two distinct theories of liability: the "traditional" or "classical" theory, and the "misappropriation" theory of insider trading.

*A. Theories of Liability: The Classical Theory
and the Misappropriation Theory*

Under the classical theory of insider trading, a corporate insider may not trade in the securities of his corporation while in possession of material, nonpublic information.¹⁰ Such trading violates section 10(b) and Rule 10b-5 because of the relationship of trust and confidence that exists between the shareholders of a corporation and corporate insiders; because of this relationship, "insiders who have obtained confidential information by reason of their position with that corporation" may not take "unfair advantage of . . . uninformed . . . stockholders."¹¹ The term "insider" refers to a broader class of persons than those traditionally considered corporate insiders and includes "temporary insiders" such as attorneys, investment bankers, consultants, and accountants.¹²

Liability, however, is not limited to those who actually trade; nor is it limited to insiders. An insider who "tips" material, nonpublic information violates section 10(b) and Rule 10b-5 if the tip breaches a fiduciary duty and the tippee (the recipient of such a tip) trades, even if the insider does not trade.¹³ The tippee may also be liable for trad-

Section 20A, 15 U.S.C. § 78t-1 (1994), and section 21A, 15 U.S.C. § 78u-1 (1994), also address insider trading, although neither defines insider trading or makes it illegal. Section 20A provides a private cause of action for those who trade contemporaneously with an insider trader. Section 21A provides the SEC with the authority to seek a civil penalty against insider traders.

¹⁰ See *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997) ("Under the 'traditional' or 'classical theory' of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information.").

¹¹ *Id.* at 652 (internal quotations omitted); see also FERRARA ET AL., *supra* note 6, § 2.01[1], at 2-2 to 2-3 (discussing the classical theory of insider trading).

¹² See *O'Hagan*, 521 U.S. at 652 ("The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation."); *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983) (discussing how such "outsiders" may become fiduciaries of a corporation and subject to the insider trading restrictions); see also FERRARA ET AL., *supra* note 6, § 2.01[1], at 2-3 (noting that the term "insiders" also refers to "quasi-insiders" such as "attorneys, investment bankers, or other professionals working as temporary agents of the corporation").

¹³ See *Task Force Report*, *supra* note 6, at 237-38 (discussing the "tipper-tippee theory" of liability); see also FERRARA ET AL., *supra* note 6, § 2.01[1], at 2-3 ("[T]he 'tip-

ing if the tipper breached his fiduciary duty by conveying the information.¹⁴

Liability under the classical theory requires a breach of an insider's duty owed to the shareholders of the corporation in whose securities the insider (or a tippee) traded.¹⁵ The classical theory thus does not impose liability where an "individual[] 'outside' a corporation purchase[s] the corporation's securities while in possession of material, nonpublic information that was obtained in a manner that did not involve an insider's breach of duty."¹⁶ Such trading has been described as "outsider trading," since the traders are outsiders of the corporation in whose securities they traded.¹⁷

Recognizing this limitation of the classical theory, the SEC and the courts developed the misappropriation theory. The misappropriation theory imposes liability where an individual "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."¹⁸ Rather than predicating liability on a fiduciary relationship between the insider and the corporation's shareholders, "the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."¹⁹ As in the case

per' . . . also incur[s] liability for insider trading, even if that corporate insider did not personally trade."). To be liable, the tipper must have received some benefit or have intended to make a pecuniary gift to the tippee. See *Dirks*, 463 U.S. at 662 ("[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.").

¹⁴ See *Dirks*, 463 U.S. at 660 ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.").

¹⁵ See *Chiarella v. United States*, 445 U.S. 222, 227-35 (1980) (explaining that there can be no fraud—and therefore no liability under section 10(b) and Rule 10b-5—absent a duty to disclose owed to the stockholders).

¹⁶ FERRARA ET AL., *supra* note 6, § 2.01[1], at 2-3.

¹⁷ See Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 198 (1991) ("Trading of this type is frequently described as 'outsider trading,' so denominated because the traders are outsiders with respect to the issuer of the securities they trade.").

¹⁸ *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

¹⁹ *Id.* A good example of the misappropriation theory is found in *O'Hagan*. In that case the defendant O'Hagan was a partner in a law firm representing Grand Met in its planned tender offer of Pillsbury (though O'Hagan himself did not do any work for Grand Met). Aware of the planned tender offer, O'Hagan traded in Pillsbury options and common stock, reaping a profit of more than \$4.3 million. See *id.* at 647-48 (describing O'Hagan's conduct).

of the classical theory, both tippers and tippees may be liable for insider trading under the misappropriation theory.²⁰

B. Reasons for the Insider Trading Prohibition

The traditional basis for the insider trading prohibition is the belief that insider trading violates our notion of "fair play" and threatens the integrity of the capital markets.²¹ As the American Bar Association

²⁰ See FERRARA ET AL., *supra* note 6, § 2.01[1], at 2-4 ("On similar reasoning, trading based on a 'misappropriated' tip generally triggers liability for both the tippee and the tipper.").

²¹ See *Task Force Report*, *supra* note 6, at 227 (asserting that the "two . . . traditional bases for prohibitions against insider trading" are the "fair play" and 'integrity of the markets' arguments"). Commentators have offered several additional arguments for the prohibitions against insider trading. See generally LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 762 (3d ed. 1995) (asserting that because insider-traders can profit on negative information, insider trading may create incentives for insiders to act against the best interests of the corporation); *Task Force Report*, *supra* note 6, at 228 (asserting that insider trading discourages prompt disclosure of information since corporate insiders have an "incentive to delay [disclosure] long enough to speculate on a stock market profit"); Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1, 17-46 (1993) (advocating the prohibition of insider trading by arguing that the prohibition reduces transaction costs); Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1452 (1967) (arguing, among other things, that insider trading subjects insiders to "a conflict of interest that may affect their judgment not only in the timing of disclosure, but also in the timing of the underlying events themselves [and] may cause such events to be created"); Bevis Longstreth, *Halting Insider Trading*, N.Y. TIMES, Apr. 12, 1984, at A27 (summarizing the arguments against insider trading and rebutting the arguments in favor of insider trading).

Some commentators, on the other hand, have argued that insider trading should not be prohibited. See generally HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966) (attacking the wisdom of the prohibition against insider trading and asserting that insider trading is a useful means of compensating entrepreneurs); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 868 (1983) (arguing that insider trading promotes market efficiency since such trading is a means of communicating information to the market and thus causes the stock price to move to its "correct" value sooner); Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 55 (1980) (concluding that "the harm caused by insider trading can be objectively measured and that so measured it does not cause any detectable injury to investors"); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970) (responding to critics of his arguments in support of insider trading).

The arguments that insider trading should be permitted, however, have gained little support in Congress. As Congressman Dingell asserted: "We strongly disagree with those who would seek to permeate our markets with this type of fraud. The arguments in favor of insider trading are rubbish." 130 CONG. REC. 20,969 (1984). And as Senator D'Amato stated: "Some commentators have called insider trading a victimless crime; however, I strongly disagree. . . . John Fedders, the Director of the Securi-

Task Force on Regulation of Insider Trading observed:

In our society, we traditionally abhor those who refuse to play by the rules, that is, the cheaters and the sneaks. A spitball pitcher, or a card shark with an ace up his sleeve, may win the game but not our respect. And if we know such a person is in the game, chances are we won't play. These commonsense [sic] observations suggest that two of the traditional bases for prohibitions against insider trading are still sound: the 'fair play' and 'integrity of the markets' arguments.²²

Underlying the development of the insider trading prohibition is the view that insider trading is fundamentally unfair.²³ As Donald Langevoort has observed, "most people who oppose insider trading seem to believe that quite apart from any harm caused to specific investors, insider trading is simply an *unfair* exploitation of information that properly belongs to someone else."²⁴ The unfairness stems not from the insider-trader's possession of superior information, but from the trader's possession of an informational advantage that other investors cannot overcome: other investors cannot acquire the inside information.²⁵ Clearly, informational advantages exist; some investors will necessarily have superior information as a result of superior intelligence, diligence, or power.²⁶ And not all such informational dispari-

ties and Exchange Commission's Division of Enforcement, has stated publicly that he believes that those who engage in insider trading are thieves, I concur wholeheartedly with Mr. Fedders." 130 CONG. REC. 20,107 (1984).

An assessment of the various arguments is beyond the scope of this Comment. Congress and the courts have embraced the "fairness" and "integrity of the markets" arguments, and this Comment will proceed under the assumption that such arguments are valid.

²² *Task Force Report*, *supra* note 6, at 227.

²³ See Cady, Roberts & Co., 40 S.E.C. 907, 911-12 (1961) (asserting that the "disclose or abstain" obligation "rests on . . . the inherent unfairness involved where a party takes advantage of . . . information knowing it is unavailable to those with whom he is dealing").

²⁴ LANGEVOORT, *supra* note 4, § 1.02[4], at 1-14.

²⁵ As Victor Brudney commented:

The unfairness is not a function merely of possessing more information – outsiders may possess more information than other outsiders by reason of their diligence or zeal – but of the fact that it is an advantage which cannot be competed away since it depends upon a lawful privilege to which an outsider cannot acquire access.

Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 346 (1979).

²⁶ See *id.* at 360 ("[T]here may nevertheless be systematic inequality of lawful access to information by reason of disparities among individual investors with respect to power, wealth, diligence, or intelligence."); see also Ronald J. Gilson, *The Outside View of Inside Trading*, N.Y. TIMES, Feb. 8, 1987, at E23 ("In the public mind, fairness is equated with access. From this perspective, what is unfair about insider trading is that

ties should be eliminated.²⁷ When other investors are unable to obtain information, however, no matter how great their resources or diligence, such informational advantages are unfair,²⁸ and it is those informational advantages that the insider trading prohibition seeks to prevent.²⁹

it is a game that only some can play, and participation is not based on merit.”).

²⁷ See Brudney, *supra* note 25, at 353 (explaining that “the need to encourage private pursuit of information sets limits on the persons and information subject to the disclosure obligations of the antifraud rules”); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 323 (“[S]ometimes nondisclosure is necessary to enable people to capture the value of information; to permit use without disclosure is to encourage the creation of new information.”).

²⁸ See Brudney, *supra* note 25, at 354 (“[T]he essential . . . element which makes an informational advantage unusable by those who possess it in dealing with those who do not is the inability of the latter to overcome it lawfully, no matter how great may be their diligence or large their resources.”).

²⁹ This is the “equality of access to information” theory. See *id.* at 354-55 (“This notion is sometimes cast in terms of a rule seeking to effect equal access to material information for persons trading with each other.”). It should be distinguished from the “parity-of-information” theory, which suggests that all informational disparities should be eliminated. See *id.* at 355 (“[V]iewed most broadly, [the equality of access to information theory] does not extend so far as to require actual equality or sharing of information.”). As Justice Blackmun explained:

[T]here is a significant conceptual distinction between parity of information and parity of *access* to material information. The latter gives free rein to certain kinds of informational advantages that the former might foreclose, such as those that result from differences in diligence or acumen. Indeed, by limiting opportunities for profit from manipulation of confidential connections or resort to stealth, equal access helps to ensure that advantages obtained by honest means reap their full reward.

Chiarella v. United States, 445 U.S. 222, 252 n.2 (1980) (Blackmun, J., dissenting); see also *Insider Trading: Some Questions and Some Answers*, 1 SEC. REG. L.J. 328, 335 (1974) (suggesting that it is “equality of access” to information (as distinguished from “equality of information”) among investors that is a goal of the antifraud provisions).

At least one commentator has argued that the insider trading laws should adopt a parity-of-information approach. See Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1137-38 (1985) (arguing that a parity-of-information rule “has clear advantages” including the fact that it is a “bright line rule” that would “reassure investors that the securities markets generally prohibit information advantages”).

The Supreme Court has explicitly rejected the parity-of-information theory. See *Chiarella*, 445 U.S. at 233 (“[N]either the Congress nor the Commission ever has adopted a parity-of-information rule.”). *Chiarella* also cast doubt upon the equal access theory, predicated liability on a fiduciary duty to shareholders. See *id.* at 231-33 (arguing that a duty to “disclose or abstain” exists only where the insider has a fiduciary duty to shareholders). The Supreme Court also appeared to reject the equal access theory in *United States v. O'Hagan*, asserting that a fiduciary could potentially avoid liability by disclosing to the source of the information his plans to trade. See *United States v. O'Hagan*, 521 U.S. 642, 655 (1997) (“[F]ull disclosure forecloses liability under the

In addition to—or perhaps because of—this fundamental unfairness, insider trading threatens the capital markets. The strength and stability of the capital markets depend on investor confidence in those markets.³⁰ Insider trading, however, undermines investors' expectations of honest and fair securities markets.³¹ If investors believe that other market participants have an unerodable informational advantage—that the markets are not fair—they will be reluctant to participate in the securities markets:

A rational buyer (or seller) in a market, who knows that the person with whom he is dealing has material information about the value of the product being exchanged which he could not lawfully acquire, will either refrain from dealing with that transactor or demand a risk premium. If the market is thought to be systematically populated with such transactors some investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors or corruptly to overcome their unerodable informational advantages.³²

misappropriation theory . . . if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no . . . § 10(b) violation.”). This assertion implicitly rejects the equal access theory, for even if the fiduciary disclosed his trading plans to the source of the information, he would still have an informational advantage that could not lawfully be overcome by other investors. *But see Chiarella*, 445 U.S. at 251 (Blackmun, J., dissenting) (endorsing the equal access theory, asserting that “I would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities”).

³⁰ See H.R. REP. NO. 98-355, at 2 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2275 (“Capital formation and our nation’s economic growth and stability depend on investor confidence in the fairness and integrity of our capital markets.”).

³¹ See *id.* (“Insider trading threatens [the capital] markets by undermining the public’s expectations of honest and fair securities markets where all participants play by the same rules.”); see also LANGEVOORT, *supra* note 4, § 1.02[4], at 1-15 (“Confidence in the securities marketplace . . . is diminished if shareholders believe that only those ‘in the know’ can profit in the stock market.”).

³² Brudney, *supra* note 25, at 356; see also *Insider Trading Sanctions and SEC Enforcement Legislation*, Hearing on H.R. 559 Before the Subcomm. on Telecomm., Consumer Protection and Finance of the House Comm. on Energy and Commerce, 98th Cong. 35 (1983) [hereinafter *House Hearings*] (statement of John M. Fedders, SEC Director of Enforcement) (“[I]f we permit [insider trading] I think it would erode investor confidence in the marketplace and they may very well flee the marketplace and choose other investments, which would hurt the liquidity of the exchanges, the liquidity of the marketplace, and eventually the capital structure of our country.”); H.R. REP. NO. 100-910, at 8 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6045 (“[T]he small investor will be—and has been—reluctant to invest in the market if he feels it is rigged against him.”); *Task Force Report*, *supra* note 6, at 227-28 (“Although [we] know[] of no empirical research that directly demonstrates that concerns about integrity affect market activity, both authoritative commentators and common sense tell us that if investors do not anticipate fair treatment, they will avoid investing in securities [and] capital forma-

It is this recognition that underlies the insider trading prohibitions.³³ Indeed, as SEC Enforcement Director William R. McLucas asserted, "one of the purposes of bringing an insider trading case, in addition to addressing specific instances of fraud, is to ensure the integrity of the market."³⁴

II. THE "POSSESSION VERSUS USE" DEBATE

Although Congress has condemned insider trading and expressed strong support for the prohibition of such conduct,³⁵ Congress has resisted attempts to expressly define insider trading.³⁶ Instead, the prohibition against insider trading has developed solely from judicial (and administrative) interpretation of the anti-fraud provisions of section 10(b) and Rule 10b-5. The lack of a statutory definition of the insider trading offense has led to some ambiguity regarding the type of conduct that is prohibited.³⁷ One such area of ambiguity is whether the insider's motivation for trading is relevant to a determination of insider-trading liability under Rule 10b-5. At issue is whether section 10(b) and Rule 10b-5 require a causal connection between the material, nonpublic information and the insider's trading—that is, a show-

tion . . . will become less attractive and more difficult.").

³³ The central purpose of the federal securities laws is "to insure the maintenance of fair and honest markets." 15 U.S.C. § 78b (1994); see also 130 CONG. REC. 20, 109 (1984) (statement of Sen. Sarbanes) (describing the Insider Trading Sanctions Act of 1984 as "much needed legislation to deter insider trading, a market abuse which threatens investor confidence in the fairness and integrity of our capital markets").

³⁴ William R. McLucas & Alma M. Angotti, *Insider Trading: Is It Back or Did It Ever Really Go Away?*, INSIGHTS, Oct. 1995, at 2, 8.

³⁵ See *supra* note 21 (quoting statements by Congressman Dingell and Senator D'Amato as representative of Congress's support for the prohibition against insider trading).

³⁶ See H.R. REP. NO. 98-355, at 13-14 (1984), reprinted in 1984 U.S.C.C.A.N. 2274, 2286-87 (explaining that Congress decided not to define insider trading). The SEC has also been reluctant to define insider trading. See 2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(610), at 7:160.4 ("Congress and the SEC strongly resisted pleas from the bar to define insider trading."); William R. McLucas et al., *Common Sense, Flexibility, and Enforcement of the Federal Securities Laws*, 51 BUS. LAW. 1221, 1235 n.71 (1996) (noting that the SEC submitted a proposed definition of insider trading to Congress in 1987 despite the SEC's historical position "that a codified definition . . . was unnecessary and indeed, counterproductive," but explaining further that legislative efforts to define insider trading have nonetheless been unsuccessful).

³⁷ See Fisch, *supra* note 17, at 179-80 & n.5 (asserting that "the legal restrictions on trading securities while in possession of material nonpublic information are confused and confusing" and that "the legal uncertainty has been attributed to the absence of a statute defining the prohibited conduct"); see also SZOCKY, *supra* note 9, at 1, 105 (referring to the "vagueness" of the insider trading prohibition).

ing that the insider actually used the information in making his decision to trade—or whether knowing possession of such information at the time of the trade is sufficient for liability.³⁸ The SEC, as well as some legal commentators, have advocated a “knowing possession” standard, arguing that the insider’s motivation for trading is largely irrelevant.³⁹ Other commentators, however, have advocated a “use”

³⁸ Although organizations can be subject to insider trading liability under the Insider Trading and Securities Fraud Enforcement Act of 1988 (“ITSFEA”), Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.), see, e.g., H.R. REP. NO. 100-910, at 7 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6044 (explaining that the bill “expand[s] the scope of civil penalties remedies to ‘controlling persons’ who fail to take adequate steps to prevent insider trading”), the “possession versus use” debate has focused primarily on trading by individuals, rather than by organizations. Although one might argue that the debate should include corporate trading, a discussion of corporate trading is beyond the scope of this Comment.

Organizations frequently trade while in possession of material, nonpublic information—often one department of an organization will trade while another department possesses inside information about the traded securities. See John H. Sturc & Catharine W. Cumber, *Possession vs. Use for Insider Trading Liability*, INSIGHTS, June 1998, at 3, 7 (explaining that a “common situation is that of an institutional investor with separate departments, one of which may possess material nonpublic information and another which engages in trading”). But such organizations may avoid liability—even under a “knowing possession” standard—by erecting a “Chinese Wall,” which is essentially a set of policies and procedures designed to prevent the communication of information between departments. See Marc I. Steinberg & John Fletcher, *Compliance Programs for Insider Trading*, 47 SMU L. REV. 1783, 1803-04 (1994) (“Chinese Wall procedures consist of policies and procedures designed to control the flow of material, nonpublic information within a multiservice financial firm.”). If a Chinese Wall is in place, inside information possessed by individuals on one side of the wall will not be imputed to those on the other side of the wall who are engaged in trading activities. See Horwich, *supra* note 5, at 1238 (“This [lack of imputation] is understood to free the organization to trade even if trading ‘while in possession’ of inside information is unlawful.”). Although few courts have addressed whether a Chinese Wall can be used by an organization to avoid federal securities liability, the SEC explicitly approved the use of Chinese Walls when it adopted Rule 14e-3. See 17 C.F.R. § 240.14e-3(b) (1999) (providing a safe harbor for organizations implementing Chinese Wall procedures provided it can be shown that the “individual(s) making the investment decision on behalf of the [organization] . . . did not know the material, nonpublic information”); Steinberg & Fletcher, *supra*, at 1810-12 (discussing judicial and administrative treatment of Chinese Walls).

³⁹ See SEC v. Adler, 137 F.3d 1325, 1332-33 (11th Cir. 1998) (noting that the SEC claimed that “knowing possession of material, nonpublic information while trading is sufficient to establish liability” and that the SEC argued that evidence that the defendant knowingly possessed material, nonpublic information at the time of his trade was sufficient to impose insider trading liability, regardless of whether or not the defendant used the inside information); FERRARA ET AL., *supra* note 6, § 2.01[5], at 2-14.6 to 2-14.8 (implicitly endorsing the “knowing possession” standard—at least under the classical theory of insider trading liability); LANGEVOORT, *supra* note 4, § 3.04, at 3-23 to 3-27 (suggesting that “knowing possession” is the appropriate test); 7 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3505 (3d ed. 1991) (advocating the “knowing

standard, arguing that a causal connection between the inside information and the insider's trading activity is required.⁴⁰

In many insider trading cases, the difference between these two standards is irrelevant, since it is clear that the insider traded on the basis of the material, nonpublic information.⁴¹ The issue can become important, however, in certain situations. Consider, for example, the following situation:

The chief financial officer ["CFO"] of a publicly held company has consistently bought shares (in the range of 2,000 to 5,000 shares) in his company during a two- or three-day window period beginning the day after the filing of the company's quarterly report on Form 10-Q. Based on the advice of house counsel, this timing was intended to protect the CFO from any charges that he possessed non-public information. But in the instant case, the day after the filing of its Form 10-Q, the company (and its senior officers) become aware of a lucrative merger proposal from a well-financed acquirer. Knowing that such a merger was under negotiation, the CFO still buys his more-or-less customary 5,000 shares (and thereby profits handsomely when the nonpublic proposal is eventually announced).⁴²

In this situation, the CFO's liability for insider trading may depend upon whether the "knowing possession" or the "use" standard is employed. Under the SEC's "knowing possession" test, the CFO will be liable for insider trading—regardless of the fact that he always buys shares after the company files its quarterly report and regardless of his motivation for his current purchase of shares. Under the "use" test, however, the CFO will escape liability as long as his decision to buy shares was not based on his knowledge of the contemplated merger—

possession" standard); Oriana N. Li, Note, *United States v. Smith: The Use-Possession Debate in SEC Enforcement Actions Under § 10(b)*, 74 WASH. L. REV. 395, 401-24 (1999) (arguing that the Ninth Circuit erred in *Smith* by rejecting the "knowing possession" standard).

⁴⁰ See 2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(610) to (620), at 7:160.1 to 7:160.13 (advocating the "use" standard); Christopher J. Bebel, *A Detailed Analysis of United States v. O'Hagan: Onward Through the Evolution of the Federal Securities Laws*, 59 LA. L. REV. 1, 50-53 (1998) (arguing that the Supreme Court's opinion in *O'Hagan* supports a "use" standard); Horwich, *supra* note 5, at 1268-76 (discussing numerous factors which "all point in favor of a use component"); Bryan C. Smith, Comment, *Possession Versus Use: Reconciling the Letter and Spirit of Insider Trading Regulation Under Rule 10b-5*, 35 CAL. W. L. REV. 371, 381-86 (1999) (arguing that the policy considerations underlying the insider trading prohibition support a "use" standard).

⁴¹ See LANGEVOORT, *supra* note 4, § 3.04, at 3-22 ("In the typical case, there is no question that the insider traded in order to take advantage of material nondisclosed information.").

⁴² John C. Coffee, Jr., *Outsider Trading After O'Hagan*, CORP. COUNSELLOR, Dec. 1997, at 6, 16.

as long as this information was not a factor in his decision to purchase the shares. In this context, then, the "possession versus use" debate may be quite important.

Attempting to resolve this debate, the Ninth and Eleventh Circuits recently held that "knowing possession" is not sufficient to impose insider trading liability.⁴³ This Part will discuss the "possession versus use" debate, exploring both the origins of the debate and the recent cases addressing the issue.

A. Origins of the Debate

Federal insider trading case law can be traced back to the SEC's seminal opinion in *Cady, Roberts & Co.*, in which the SEC concluded that insider trading constitutes "fraud or deceit" and thus violates Rule 10b-5.⁴⁴ In so doing, the SEC articulated the oft-cited "disclose or ab-

⁴³ See *United States v. Smith*, 155 F.3d 1051, 1069 (9th Cir. 1998) ("[W]e reject the government's proffered 'knowing possession' standard for insider trading violations . . ."), *cert. denied*, 119 S. Ct. 804 (1999); *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998) ("[M]ere knowing possession . . . is not a *per se* violation.").

⁴⁴ 40 S.E.C. 907, 913 (1961) (asserting that the conduct of a broker who traded on the basis of material, nonpublic information violated Rule 10b-5). *Cady, Roberts* was not the first case to hold that section 10(b) and Rule 10b-5 prohibit insider trading. Several years earlier, in *Kardon v. National Gypsum Co.*, a federal district court reached a similar conclusion, see 73 F. Supp. 798, 800 (E.D. Pa. 1947) (holding defendant corporate officers and directors liable under section 10(b) and Rule 10b-5 because they "fail[ed] to disclose a fact coming to their knowledge by reason of their position, which . . . materially affect[ed] the judgment of the other party to the transaction"), and other courts followed suit. See FERRARA ET AL., *supra* note 6, § 2.02[1], at 2-14.9 ("Since *Kardon v. National Gypsum Co.* in 1947, courts have adopted the position that Section 10(b) . . . and Rule 10b-5 require corporate insiders such as officers and directors to abstain from trading in their own corporation's securities unless they have disclosed all material nonpublic information."). But *Kardon* and other cases preceding *Cady, Roberts* involved face-to-face transactions between insiders and stockholders, not impersonal transactions on a securities exchange. See *id.* at 2-15 (explaining that "*Kardon* and other early cases . . . involved only face-to-face transactions between corporate officers and shareholders" and that "*Cady, Roberts* was . . . the first case in which Rule 10b-5 was interpreted by the SEC to ban *all* securities trading based on misuse of corporate information, including market transactions consummated through an impersonal securities market").

Long before the adoption of section 10(b) and Rule 10b-5, state common law dealt with insider trading. See Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35, 37-39 (1986) (discussing the history of the insider trading prohibition under state common law). Courts adopted several different approaches to insider trading, but in general, insider trading was prohibited only in the case of face-to-face transactions with shareholders or others to whom the insider owed a fiduciary duty—no duty of disclosure existed for impersonal securities exchange transactions. See *id.* at 38 ("[The insider trading rules] applied only where the insider engaged in face-to-face transactions with existing shareholders. In exchange transac-

stain rule," asserting that an insider is required to disclose material, nonpublic information or abstain from trading.⁴⁵ The Second Circuit embraced this rule in *SEC v. Texas Gulf Sulphur Co.*, holding that "anyone in possession of material inside information must either disclose it to the investing public, or if he is disabled from disclosing it . . . or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."⁴⁶

Courts and commentators, however, have failed to reach a consensus on the correct interpretation of the "disclose or abstain" rule. To some, the rule suggests that mere possession of nonpublic information is sufficient to establish insider trading liability, and the rule has in fact been cited for such a proposition.⁴⁷ Others have insisted that the maxim "disclose or abstain" fails to "capture the complexity of the idea that [it is] supposed to represent," and have argued that it "enjoins not *all* trading, but [only] trading *on the basis of material non-public information*."⁴⁸

tions, the uniform rule was that no duty of disclosure existed.").

Indeed, before the federal securities legislation was enacted in 1934, "insider trading was tacitly viewed as a perk for corporate executives." SZOCKY, *supra* note 9, at 5. "[M]any, if not most, of America's great fortunes accumulated at the end of the 19th century and the beginning of the 20th were built with information—about pending government contracts, disasters, wars, new inventions or techniques—that was not available to the public at large." MORTON SHULMAN, *THE BILLION DOLLAR WINDFALL* 122 (1970).

⁴⁵ See *Cady, Roberts*, 40 S.E.C. at 911 (asserting that "insiders must disclose material facts" but that if "disclosure . . . would be improper or unrealistic . . . the alternative is to forego the transaction"); *id.* at 914 ("If purchasers on an exchange had available material information known by a selling insider, we may assume that their investment judgment would be affected and their decision whether to buy might accordingly be modified. Consequently, any sales by the insider must await disclosure of the information.").

⁴⁶ 401 F.2d 833, 848 (2d Cir. 1968). The "disclose or abstain" rule was ultimately validated by the Supreme Court in *Chiarella v. United States*, 445 U.S. 222, 226-27 (1980) (citing with approval the SEC's assertion in *Cady, Roberts* that an insider has an obligation to disclose material, nonpublic information or abstain from trading). *Texas Gulf Sulphur* arguably went further than *Cady, Roberts* and *Chiarella* by advocating a parity-of-information approach. See *supra* note 29 (discussing the parity-of-information theory).

⁴⁷ See, e.g., *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir. 1993) ("[A] 'knowing possession' standard comports with the oft-quoted maxim that one with a fiduciary or similar duty to hold material, nonpublic information in confidence must either 'disclose or abstain' with regard to trading."); Horwich, *supra* note 5, at 1240 (explaining that *Cady, Roberts* can be read in support of a "knowing possession" test).

⁴⁸ *United States v. Smith*, 155 F.3d 1051, 1068-69 (9th Cir. 1998). In reaching the conclusion that the "disclose or abstain" rule was meant to prohibit insiders from using nonpublic information when trading, not to enjoin trading merely because the insider possesses nonpublic information, the *Smith* court made two observations. The court

Even the SEC appears to have wavered in its interpretation of the "disclose or abstain" rule. Despite the assertion by SEC Enforcement Director William R. McLucas that the Commission has always advocated "knowing possession" as the appropriate rule for insider trading liability,⁴⁹ the SEC has been inconsistent in its interpretation of the rule. In *Investors Management Co.*, for example, the SEC effectively endorsed a "use" requirement, asserting that a requisite element for insider trading liability is "that the information be a factor in [the] decision to effect the transaction."⁵⁰ The SEC continued to explain: "[W]here a transaction . . . is effected by the recipient [of material, nonpublic information] prior to its public dissemination, an inference arises that the information was . . . a factor. The recipient of course may seek to overcome such inference by countervailing evidence."⁵¹ But in *Sterling Drug, Inc.*, the SEC rejected the "use" requirement suggested by *Investors Management* and instead endorsed the "knowing possession" standard, asserting:

The Commission . . . believes that Rule 10b-5 . . . does not require a showing that an insider sold his securities for the purpose of taking advantage of material non-public information. . . . If an insider sells his securities while in possession of material adverse non-public information, such an insider is taking advantage of his position to the detriment of

noted that in *Cady, Roberts*, it was clear that "the suspected insider traders had, in fact, used inside information in consummating their trades." *Id.* at 1069. The court further noted that "the SEC premised its decision, at least in part, on the proposition that '[a] significant purpose of the Exchange Act was to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office.'" *Id.* (citing *Cady, Roberts*, 40 S.E.C. at 912 n.15). See also Horwich, *supra* note 5, at 1239-40 ("Based on this language and the cited support for it, the essence of the violation of rule 10b-5 would appear to be making affirmative use of the information for personal advantage.").

⁴⁹ See McLucas & Angotti, *supra* note 34, at 4 ("The Commission has always taken the position that once a person learns of, or 'comes into possession of,' material information, that person must either disclose the information or abstain from trading.").

⁵⁰ 44 S.E.C. 633, 641 (1971).

⁵¹ *Id.* at 646-47. There was little evidence, however, that the transactions at issue in this case were not motivated by inside information. See *id.* at 647 n.28 ("The examiner rejected contentions by various of the respondents that their sales of . . . stock were motivated by factors other than the . . . information."). In a concurring opinion, Commissioner Smith recommended a stricter test, asserting that "the information must be shown . . . to have substantially contributed to the trading which occurred." *Id.* at 651. Commissioner Smith explained that he did "not read [the majority's] requirement that the information be 'a factor' as, for instance, encompassing situations where a firm decision to effect a transaction had clearly been made prior to the receipt of the information and the information played no substantial role in the investment decision." *Id.*

the public.⁵²

In neither of these opinions, however, did the SEC articulate a rationale for its position.⁵³ The SEC's seemingly abrupt and unexplained shift in position has served only to exacerbate the ambiguity and has made some reluctant to accord much deference to the Commission's position that "knowing possession" is the appropriate test.⁵⁴

B. Recent Cases Addressing the "Possession Versus Use" Debate

More recently, three federal circuit courts have expressly examined the issue of "possession versus use."

1. The Possession Standard: *United States v. Teicher*

The first case to discuss carefully the "possession versus use" debate was *United States v. Teicher*.⁵⁵ In *Teicher*, the defendants argued that the district court erroneously instructed the jury that the defendants could be found guilty of insider trading if they possessed material, nonpublic information at the time of their trades, regardless of whether this information was the actual cause of those trades.⁵⁶ Al-

⁵² *Sterling Drug, Inc.*, 14 S.E.C. Docket 824, 827 (1978). In *Sterling Drug*, three directors accused of insider trading maintained that they had decided to sell stock in the company prior to obtaining the inside information. One director presented documentary evidence that he had formed an intention to sell prior to obtaining the information and testified that he sold stock because he had retired from his position and wished to diversify his investments. The other two directors testified that they sold stock to satisfy various obligations. See *id.* at 827 (discussing the directors' testimony regarding their reasons for selling stock).

⁵³ The SEC did not cite any authority for its assertion in *Sterling Drug*, nor did the SEC reference its opinion in *Investors Management*.

⁵⁴ See *infra* notes 82-85 and accompanying text (explaining that the Eleventh Circuit has declined to accord much deference to the SEC's position regarding the "possession versus use" debate since the SEC's position has not been consistent over time).

⁵⁵ 987 F.2d 112 (2d Cir. 1993). See LANGEVOORT, *supra* note 4, § 3.04, at 3-23 ("The first extensive judicial discussion of this issue is found in . . . *United States v. Teicher*"). The case has also been referred to as the "leading case" in support of the "knowing possession" standard. Horwich, *supra* note 5, at 1250.

⁵⁶ *Teicher*, 987 F.2d at 119 (discussing the defendants' arguments). The district court instructed the jury:

The government need not prove a causal relationship between the misappropriated material nonpublic information and the defendants' trading. That is, the government need not prove that the defendants purchased or sold securities because of the material nonpublic information that they knowingly possessed. It is sufficient if the government proves that the defendants purchased or sold securities while knowingly in possession of the material nonpublic information.

though merely dicta, the Second Circuit expressly rejected the "use" requirement advocated by the defendants and instead endorsed a "knowing possession" standard.⁵⁷ The court began by observing that "Rule 14e-3, which prohibits fraud in connection with tender offers explicitly provides a 'knowing possession' standard."⁵⁸ The court then set forth three factors in support of its position.⁵⁹

First, the *Teicher* court stated that section 10(b) and Rule 10b-5 require only that a deceptive practice be conducted "'in connection with the purchase or sale of a security.'"⁶⁰ The court noted that the phrase "in connection with" has been construed quite flexibly, suggesting that such an interpretation supports the more flexible and less restric-

Id.

⁵⁷ See *id.* at 120-21 (rejecting the defendants' arguments and asserting that "a number of factors weigh in favor of a 'knowing possession' standard"). The court's adoption of the "knowing possession" standard was dicta since the court found it "unnecessary to determine whether proof of securities fraud requires a causal connection, because any alleged defect in the instruction was harmless beyond doubt." *Id.* at 121.

⁵⁸ *Id.* at 120. Rule 14e-3 provides in relevant part:

(a) If any person has taken a substantial step or steps to commence . . . a tender offer, . . . it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

- (1) The offering person,
- (2) The issuer of the securities sought . . . by such tender offer, or
- (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell . . . such securities . . . unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3 (1999).

The applicability of Rule 14e-3's "knowing possession" standard to the "possession versus use" debate is somewhat questionable. In section 14(e), Congress expressly gave the SEC the power to define fraud: "The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 78n(e) (1998). The SEC's definition of fraud contained in Rule 14e-3 may not be transferable to section 10(b) and Rule 10b-5 fraud.

⁵⁹ See *Teicher*, 987 F.2d at 120-21. In addition to the factors discussed, the court also asserted that the SEC's interpretation of Rule 10b-5 is "entitled to some consideration." *Id.* at 120. Citing *Sterling Drug, Inc.*, the court noted that the SEC has "consistently endorsed [the view] that a violation of § 10(b) and Rule 10b-5 occurs when a trade is conducted in 'knowing possession' of material nonpublic information obtained in breach of a fiduciary or similar duty." *Id.* For a discussion of *Sterling Drug, Inc.*, see *supra* note 52 and accompanying text.

⁶⁰ *Teicher*, 987 F.2d at 120 (quoting section 10(b) and Rule 10b-5).

tive "knowing possession" standard.⁶¹

Second, the court argued that the "disclose or abstain" rule supports the "knowing possession" standard.⁶² The court explained that if an insider is in possession of material, nonpublic information and he chooses not to disclose such information, he must abstain from trading.⁶³

Finally, and perhaps most persuasively, the court recommended the "knowing possession" standard because it is simple to apply, requiring only a determination of whether the trader possessed material, nonpublic information.⁶⁴ The "use" standard, on the other hand, requires factual inquiries into the state of mind and motivations of the trader.⁶⁵ The court further suggested that it would be unlikely that information possessed by a trader would not in some way influence his trades. As the court explained:

Unlike a loaded weapon which may stand ready but unused, material information can not lay idle in the human brain. The individual with such information may decide to trade upon that information, to alter a previously decided-upon transaction, to continue with a previously planned transaction even though publicly available information would now suggest otherwise, or simply to do nothing.⁶⁶

The court believed that a "use" standard would pose difficulties of proof for the SEC or the government and would "frustrate attempts to distinguish between legitimate trades and those conducted in connection with inside information."⁶⁷

⁶¹ See *id.* at 120 ("We have previously stated that the 'in connection with' clause must be 'construed . . . flexibly to include deceptive practices 'touching' the sale of securities, a relationship which has been described as 'very tenuous . . .'" (quoting *United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981))); see also LANGEVOORT, *supra* note 4, § 3.04, at 3-23 (explaining that the *Teicher* court believed that "the possession standard better comports with the view that Rule 10b-5 should be read flexibly, not restrictively").

⁶² See *Teicher*, 987 F.2d at 120 ("[A] 'knowing possession' standard comports with the oft-quoted maxim that one with a fiduciary or similar duty to hold material non-public information in confidence must either 'disclose or abstain' with regard to trading.").

⁶³ See *id.* ("When the . . . insider . . . is not in a position to make a public announcement, [he] must abstain.").

⁶⁴ See *id.* ("Finally, a 'knowing possession' standard has the attribute of simplicity.").

⁶⁵ See FERRARA ET AL., *supra* note 6, § 2.01[5], at 2-14.6 (explaining that the *Teicher* court believed that "a 'use' test would entail significant factual inquiries into the state of mind and the motivations of the insider trader").

⁶⁶ *Teicher*, 987 F.2d at 120.

⁶⁷ *Id.* at 121.

2. The Use Standard: *SEC v. Adler* and *United States v. Smith*

Although *Teicher* devoted considerable attention to the "possession versus use" debate, the Second Circuit's discussion was merely dicta.⁶⁸ The first circuit court to directly confront the issue was the Eleventh Circuit in *SEC v. Adler*.⁶⁹ In that case, the district court effectively adopted a "use" standard for insider trading, granting summary judgment for one of the defendants because he had a preexisting plan to sell stock.⁷⁰ On appeal, the SEC argued that the district court erred in granting summary judgment, asserting that the defendant knowingly possessed material, nonpublic information and that such knowing possession was sufficient for liability.⁷¹ Viewing the choice between the "possession" and "use" standards as "a difficult and close question of first impression," the Eleventh Circuit concluded that "the use test is the appropriate test."⁷² The court asserted, however, that an "inference of use . . . arises from the fact that an insider traded while in possession of inside information."⁷³

Acknowledging that the Supreme Court's language in several cases was merely dicta, the *Adler* court nonetheless felt that its "use" test "best comports with the language of § 10(b) and Rule 10b-5, and with Supreme Court precedent."⁷⁴ The court noted, for example, the "use" language employed throughout the Supreme Court's opinions in *Chiarella v. United States*,⁷⁵ *Dirks v. SEC*,⁷⁶ and *United States v. O'Hagan*.⁷⁷ The court also asserted that the Supreme Court's language in those opinions "repeatedly emphasized [a] focus on fraud and deception,"⁷⁸ and argued that a "knowing possession" test fails to embody such a focus: "[W]e do not believe that the SEC's knowing possession test would always and inevitably be limited to situations involving

⁶⁸ See *supra* note 57 (explaining why the court's discussion was dicta).

⁶⁹ 137 F.3d 1325 (11th Cir. 1998).

⁷⁰ See *id.* at 1332 (explaining that the district court granted summary judgment for one of the defendants because his "preexisting plan to sell stock rebutted any reasonable inference of scienter").

⁷¹ See *id.* ("The SEC argues that it presented evidence that [the defendant] knowingly possessed material nonpublic information, and thus . . . violated the prohibition against insider trading . . .").

⁷² *Id.* at 1337.

⁷³ *Id.*

⁷⁴ *Id.* at 1338.

⁷⁵ 445 U.S. 222 (1980).

⁷⁶ 463 U.S. 646 (1983).

⁷⁷ 521 U.S. 642 (1997).

⁷⁸ *Adler*, 137 F.3d at 1338.

fraud."⁷⁹

The *Adler* court found support for its position in other cases as well. Citing cases including *In re Worlds of Wonder Securities Litigation*,⁸⁰ the court noted that several other courts "have allowed insiders to introduce evidence of preexisting plans or other 'innocuous' reasons for sales in order to" escape liability.⁸¹

Furthermore, although the SEC advocated a "knowing possession" standard, the court refused to defer to the SEC's position.⁸² The *Adler* court asserted that the SEC position had not been consistent, noting that in *Investors Management*⁸³ the SEC appeared to support a "use" test, but that in *Sterling Drug*⁸⁴ the SEC adopted a "knowing possession" test without providing any rationale for the change.⁸⁵ The court also observed that although the SEC had expressly adopted a "knowing possession" standard in the context of tender offers with Rule 14e-3,⁸⁶ the SEC had not amended Rule 10b-5 or promulgated other rules adopting the "knowing possession" test for the more general case of insider trading.⁸⁷

Finally, the court considered the Insider Trading Sanctions Act of 1984. Although acknowledging that Congress used the phrase "in possession of" in the statute, the court nonetheless concluded that the

⁷⁹ *Id.*

⁸⁰ 35 F.3d 1407 (9th Cir. 1994) [hereinafter *Worlds of Wonder*].

⁸¹ *Adler*, 137 F.3d at 1335.

⁸² *See id.* at 1339 ("We decline to accord much deference to the SEC position . . .").

⁸³ 44 S.E.C. 633 (1971).

⁸⁴ 14 S.E.C. Docket 824 (1978).

⁸⁵ *See Adler*, 137 F.3d at 1339 (explaining that the SEC's position regarding the "possession versus use" debate has not been consistent over time); *see also supra* notes 50-52 and accompanying text (discussing the SEC's positions in *Investors Management* and *Sterling Drug*).

⁸⁶ Rule 14e-3 prohibits trading in securities while in possession of material, non-public information, if such securities are being sought (or will be sought) in a tender offer. *See* 17 C.F.R. § 240.14e-3 (1999) (providing that "it shall constitute a fraudulent, deceptive or manipulative act or practice . . . for [a] person who is in possession of material [nonpublic] information relating to [a] tender offer . . . to purchase or sell . . . such securities"); *supra* note 58 and accompanying text (discussing Rule 14e-3).

⁸⁷ *See Adler*, 137 F.3d at 1339 ("[A]lthough the SEC has adopted such a rule in the context of tender offers, it has not formally adopted the knowing possession test for insider trading."). Some have questioned the SEC's ability to promulgate such a rule under section 10(b). *See Sturc & Cummer, supra* note 38, at 6 (asserting that the *Adler* court's "assumption about the SEC's rulemaking authority is questionable," because "Section 10(b) does not give the SEC the same authority to make rules 'reasonably designed to prevent' any acts and practices which may violate the statute as does Section 14(e), but rather only the authority to proscribe the deceptive devices themselves").

"language of [the Insider Trading Sanctions Act] does not resolve whether possession or use is the proper standard for an insider trading violation."⁸⁸

The court noted that "[t]he strongest argument that has been articulated in support of the knowing possession test is that a strict use test would pose serious difficulties of proof for the SEC."⁸⁹ Agreeing that a trader's motivations are often difficult to prove, the court held that an "inference of use . . . arises from the fact that the insider traded while in knowing possession of material nonpublic information."⁹⁰ The *Adler* court asserted that such an inference would be sufficient to alleviate the problems of proof.⁹¹

Shortly after the Eleventh Circuit addressed the "possession versus use" debate, the Ninth Circuit addressed the issue in *United States v. Smith*.⁹² The *Smith* court agreed with much of the reasoning in *Adler*⁹³ and adopted the "use" standard.⁹⁴ Because *Smith* involved a criminal prosecution, however, the court stopped short of *Adler*'s holding that an inference of use arises when the insider trades while in possession of material, nonpublic information: "[W]e deal here with a criminal prosecution, not a civil enforcement proceeding, as was the situation in *Adler*. We are therefore not at liberty, as was the *Adler* court, to establish an evidentiary presumption that gives rise to an inference of use."⁹⁵

⁸⁸ *Adler*, 137 F.3d at 1337; see also *infra* Part II.C (discussing the Insider Trading Sanctions Act and Congress's role in the "possession versus use" debate).

⁸⁹ *Adler*, 137 F.3d at 1337.

⁹⁰ *Id.*; see also *id.* ("[W]hen an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading. The insider can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade . . .").

⁹¹ *Id.* ("[W]e believe that the SEC's problems [with respect to proof] are sufficiently alleviated by the inference of use . . .").

⁹² 155 F.3d 1051 (9th Cir. 1998).

⁹³ See *id.* at 1068 (agreeing with the *Adler* court that "a 'use' requirement [is] more consistent with the language of § 10(b) and Rule 10b-5, which emphasizes 'manipulation,' 'deception,' and 'fraud'"); *id.* ("Like our colleagues on the Eleventh Circuit, we are concerned that the SEC's 'knowing possession' standard would not be—indeed, could not be—strictly limited to those situations actually involving intentional fraud.").

⁹⁴ See *id.* at 1069 (holding that Rule 10b-5 requires the government to "demonstrate that the suspected inside[r] trader actually used material nonpublic information in consummating his transaction").

⁹⁵ *Id.*

C. Congressional Role in the Debate

Congress also appeared to weigh in on the "possession versus use" debate when it enacted the Insider Trading Sanctions Act of 1984 ("ITSA").⁹⁶ The major purpose of the ITSA was to increase the sanctions for insider trading by creating a new civil penalty.⁹⁷ In creating the new civil penalty, however, Congress explicitly adopted a "possession" standard: the SEC may seek the civil penalty from any person who violates a rule or statutory provision by "purchasing or selling a security *while in possession of material, nonpublic information*."⁹⁸

When it adopted the ITSA, Congress expressly declined to define insider trading.⁹⁹ Nonetheless, during the hearings on the proposed legislation, Congress examined the "possession versus use" debate, entertaining testimony from various witnesses regarding the appropriate standard. Several witnesses urged that Congress employ "use" language, arguing that the "possession" standard was inappropriate and

⁹⁶ Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

⁹⁷ See H.R. REP. NO. 98-355, at 1 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2274 (describing the purpose of the ITSA). Prior to the enactment of the ITSA, the only remedies available to the SEC for insider trading violations were injunctions against future violations and disgorgement orders, requiring defendants to pay the profits gained (or losses avoided). See Russell B. Stevenson, Jr., *The Insider Trading Sanctions Act: Some Unfinished Business Ahead*, NAT'L L.J., Oct. 15, 1984, at 18 (discussing the remedies available to the SEC prior to the passage of the ITSA). The ITSA created additional remedies, giving the SEC the authority to seek a civil penalty of up to three times the amount of profit gained or loss avoided from insider trading. The statute also increased the maximum fine for a criminal violation (not necessarily limited to insider trading) from \$10,000 to \$100,000. See H.R. REP. NO. 98-355, at 1 (summarizing the ITSA).

⁹⁸ Securities Exchange Act of 1934, § 21A(a)(1), 15 U.S.C. § 78u-1(a)(1) (1994) (emphasis added). Note that four years later, Congress employed the same "possession" language in the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.). See Securities Exchange Act of 1934, § 20A(a), 15 U.S.C. § 78t-1(a) (1994) ("Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security *while in possession of material, non-public information* shall be liable" (emphasis added)).

⁹⁹ See H.R. REP. NO. 98-355, at 13-14 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2286-87 (explaining that the Committee decided not to define insider trading in the new legislation). Some congressional witnesses suggested that Congress should define insider trading. Congress, however, resisted such pleas, arguing that because the insider trading law was "sufficiently well-developed . . . to provide adequate guidance," a definition was not needed and that a definition could reduce flexibility and create new ambiguities. *Id.* at 13; see also 2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(610), at 7:160.4 ("Congress and the SEC strongly resisted pleas from the bar to define insider trading.").

could subject defendants to the new penalty even if their motives for trading were innocent.¹⁰⁰ The SEC, on the other hand, advocated the "possession" standard.¹⁰¹

Advocates of the "use" standard have argued that the ITSA's "possession" language does not resolve the "possession versus use" debate, asserting that the ITSA does not define the insider trading violation and merely sets "a condition for the SEC to seek the civil penalty which is discretionary with the court and which is implicitly dependent on the court finding a violation."¹⁰² They argue that the "possession" standard is a "necessary condition for the civil penalty," but that Congress did not intend for "possession" to be "a sufficient condition for the penalty, much less for the violation."¹⁰³ These advocates contend that by employing the "possession" language, Congress chose not to involve itself in the "possession versus use" debate, leaving it to the courts to decide whether insider trading violations require use of material, nonpublic information or whether mere possession is sufficient.¹⁰⁴ Their arguments appear to be supported by the testimony of

¹⁰⁰ See *The Insider Trading Sanctions Act of 1983: Hearing on H.R. 559 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong. 116 (1984) [hereinafter *Senate Hearings*] (statement of Faith Colish, attorney) (asserting that "it is important to distinguish between possession and use of [inside] information"); *id.* at 126 (statement of the Securities Industry Association) (explaining that "[t]he legislation should . . . be couched in terms of trading 'on the basis of' covered information"); *House Hearings*, *supra* note 32, at 196-98 (statement of Arnold S. Jacobs, attorney) (asserting that the "use," not the "possession" standard reflects the insider trading case law); *id.* at 296-97 (statement of the New York State Bar Association Committee on Securities Regulation) (explaining that "the critical conduct is not the purchase or sale of a security 'while in the possession' of material non-public information; rather, it is the purchase or sale of a security 'on the basis' of material non-public information"); see also 2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(610), at 7:160.3 ("Congress chose the 'possession' language despite objections from a number of witnesses that it was incorrect or inappropriate."); Stevenson, *supra* note 97, at 18 ("Several congressional witnesses urged that this [possession] language be amended to limit the penalty's applicability to people who traded 'on the basis of' material non-public information.").

¹⁰¹ See *House Hearings*, *supra* note 32, at 48 (statement of Daniel L. Goelzer, SEC General Counsel) (asserting that "possession of material inside information is the test").

¹⁰² 2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(610), at 7:160.3; see also *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998) (adopting this argument).

¹⁰³ 2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(610), at 7:160.4.

¹⁰⁴ See Stevenson, *supra* note 97, at 20 (suggesting that Congress did not employ the "on the basis of" language in the ITSA because it "chose not to enroll itself in resolving definitional nuances"); see also WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 4.4.5, at 184 (1996) ("Choice of the phrase 'while in possession of' could be either an endorsement of the broader [possession] standard or a refusal to choose between the two standards."); Stuart J. Kaswell, *An Insider's View of the Insider Trading and*

SEC Director of Enforcement, John M. Fedders. When the Committee was considering the "possession versus use" issue, Fedders explained:

The proposed legislation in my view goes to a remedy. It does not at the present time at all impact the existing case law with regard to insider trading. It is strictly a remedy saying that if a person engages in this insider trading, however defined, that then the amount of disgorgement can be three times the ill-gained profit. And the proposed language that you have before you, presented by the Commission, does not impact the "based on," "in possession of," or a "knowing" standard at all.¹⁰⁵

But Professor Langevoort has argued that, although Congress chose not to define insider trading, it did endorse the "possession" standard.¹⁰⁶ Noting that Congress examined the "possession versus use" debate and heard testimony on both sides of the issue, Langevoort argues that Congress was well aware of the implications of its decision to include the "possession" language.¹⁰⁷

Securities Fraud Enforcement Act of 1988, 45 BUS. LAW. 145, 158 n.57 (1989) (explaining that the ITSEA's "possession" language "did not mean that [Congress] endorsed a 'possession' standard" because "[t]his language had appeared in ITSA and [Congress] simply replicated existing language," and asserting that "this legislation was entirely neutral with respect to the debate over the possession standard").

¹⁰⁵ *House Hearings*, *supra* note 32, at 49 (statement of John M. Fedders, SEC Director of Enforcement). *But see id.* ("[I]f you put the 'knowing' standard in or if you put the 'based on' standard in, you would be making our prosecutorial efforts much more difficult.").

¹⁰⁶ *See* LANGEVOORT, *supra* note 4, § 3.04, at 3-24 ("The choice of the 'while in possession of' statutory language . . . can be read as an endorsement of the broader [possession] test for insider trading liability.").

¹⁰⁷ *See* Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1290 (1984) ("[A] discussion in the course of the House hearings suggests that the drafters were aware of precisely what they were doing."); *see also* LANGEVOORT, *supra* note 4, § 3.04, at 3-24 ("[T]he legislative history is clear that this language was chosen to reflect precedent that makes motivation insignificant in determining insider trading liability."); *id.* at 3-24 n.8 ("Certainly, Congress had the opportunity to change the law to an 'on the basis of' test, but chose instead to endorse what it felt was the preferable prevailing interpretation of the law."); LOSS & SELIGMAN, *supra* note 21, at 786 ("Congress, both in the Insider Trading Sanctions Act of 1984 and in the Insider Trading and Securities Fraud Enforcement Act of 1988, opted specifically for the 'possession' test.").

Indeed, although the securities laws do not define insider trading, Congress has described insider trading as "the term used to refer to trading in the securities markets *while in possession of* 'material' information (generally, information that would be important to an investor in making a decision to buy or sell a security) that is not available to the general public." H.R. REP. NO. 98-355, at 2 (1984) (emphasis added), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2275; *see also* 130 CONG. REC. 20,107 (1984) (statement of Senator D'Amato) ("Insider trading is defined loosely as 'trading *while in possession of* material nonpublic information.'" (emphasis added)).

Having briefly reviewed the "possession versus use" debate, the next Part will examine more closely and assess the arguments that have been offered in support of the "use" standard, concluding that these arguments improperly rely on prior case law and are based on incorrect interpretations of Supreme Court precedent.

III. ARGUMENTS SUPPORTING THE "USE" STANDARD

Advocates of the "use" standard, including the *Adler* and *Smith* courts, have found support for the "use" standard in insider trading case law, especially in Supreme Court precedent.¹⁰⁸ In particular, they have observed that such precedent contains references to the "use" of inside information or to trading "on the basis of" such information. These advocates have also noted the Supreme Court's emphasis on fraud in its discussions of the insider trading prohibition. But, as will be discussed, this reliance on prior case law—and, more specifically, on Supreme Court precedent—is misplaced.

A. "Use" Language

Advocates of the "use" standard often point to the "use" language employed throughout the Supreme Court opinions addressing insider trading. They argue that this language suggests that the trader must have actually used the information to be liable for insider trading. Reliance on this "use" language, however, is inappropriate. In all of the Supreme Court cases cited by advocates of the "use" standard, it was clear that the defendants had in fact used nonpublic information in consummating their trades. As a result, it was natural for the Court to employ "use" language, and the Court was not careful about distinguishing between "possession" and "use."

In *Chiarella*, for example, the Supreme Court asserted that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."¹⁰⁹ And throughout *Chiarella*, the Supreme Court refers to the "use" of inside information and trading "on the basis of" such information.¹¹⁰ Similarly, throughout the *Dirks* opin-

¹⁰⁸ See, e.g., *Adler*, 137 F.3d at 1337 ("[W]e believe that Supreme Court dicta and the lower court precedent suggest that the use test is the appropriate test."). See generally Horwich, *supra* note 5 (providing extensive examination of insider trading case law in the context of the "possession versus use" debate).

¹⁰⁹ *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

¹¹⁰ See, e.g., *id.* at 226 (explaining that in *Cady, Roberts*, the SEC found that a broker-dealer violated § 10(b) by "selling securities on the basis of undisclosed information"

ion, the Supreme Court referred to "trading *on*"¹¹¹ inside information, and asserted that "insiders [are] forbidden . . . from personally *using* undisclosed corporate information to their advantage."¹¹² More recently, in *O'Hagan*, the Supreme Court, referring to the "'classical theory' of insider trading liability," explained that "[section] 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation *on the basis of* material, nonpublic information"¹¹³ and, referring to the misappropriation theory, asserted that "the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he *uses* the information to purchase or sell securities."¹¹⁴ The Supreme Court's repeated employment of phrases such as "on the basis of"—particularly in the recent *O'Hagan* opinion—has suggested to many observers that the Court has considered the "possession versus use" debate and has endorsed the "use" standard.¹¹⁵

(emphasis added)); *id.* at 229 ("The federal courts have found violations of § 10(b) where corporate insiders *used* undisclosed information for their own benefit." (emphasis added)); *id.* at 230 (explaining that the "duty to disclose prior to trading guarantees that corporate insiders . . . will not benefit personally through fraudulent *use* of material, nonpublic information" (emphasis added)); *id.* at 230 n.12 ("'Tippees' of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the *use* of inside information . . ." (emphasis added)); *id.* at 231 ("Petitioner's *use* of that information was not a fraud under § 10(b) unless he was subject to an affirmative duty to disclose it before trading." (emphasis added)); *id.* at 233 ("We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions *based on* material, nonpublic information." (emphasis added)); *id.* (referring to "the problems caused by *misuse* of market information" and the "*use* of market information" (emphasis added)).

¹¹¹ See, e.g., *Dirks*, 463 U.S. at 654 (explaining that in *Chiarella*, "the Court found that there is no general duty to disclose before trading *on* material nonpublic information" (emphasis added)); *id.* at 655 (referring to the "requirement of a specific relationship between the shareholders and the individual trading *on* inside information" (emphasis added)); *id.* (discussing "how a tippee acquires the *Cady, Roberts* duty to refrain from trading *on* inside information" (emphasis added)); *id.* at 661 n.21 ("Depending on the circumstances, and even where permitted by law, one's trading *on* material nonpublic information is behavior that may fall below ethical standards of conduct." (emphasis added)).

¹¹² *Id.* at 659 (emphasis added).

¹¹³ *O'Hagan*, 521 U.S. at 651-52 (emphasis added).

¹¹⁴ *Id.* at 656 (emphasis added). The Court employs similar language throughout the opinion. See, e.g., *id.* at 655-56 (examining "the § 10(b) requirement that the misappropriator's deceptive *use* of information be 'in connection with the purchase or sale of [a] security'" (emphasis added)); *id.* at 656 (referring to a "misappropriator who trades *on the basis of* material, nonpublic information" (emphasis added)); *id.* at 659 n.9 (discussing "[section] 10(b) liability when a person trad[es] *on the basis of* nonpublic information" (emphasis added)).

¹¹⁵ See Dennis J. Block & Jonathan M. Hoff, *Insider Trading Liability: 'Use v. Posses-*

As the *Adler* and *Smith* courts acknowledged, however, the Supreme Court's use of such language is merely dicta.¹¹⁶ The issue of whether possession is sufficient was not before the Court in any of those cases: in all three cases, it was clear that the defendants had in fact used the inside information in consummating their trades.¹¹⁷ Because the defendants had used the information, it was natural for the Court to employ "use" language; in referring to insider trading with "use" language, the Court was merely describing what the defendants had done in those cases.¹¹⁸ Further, because the issue of "possession versus use" was not before the Court, it is likely that the Court did not consider carefully its choice of language in that context.¹¹⁹ Indeed, in

tion,' N.Y.L.J., Oct. 29, 1998, at 5 ("[S]everal commentators have suggested that *O'Hagan* substantially undermines the SEC's 'possession' theory . . ."); Harvey L. Pitt & Karl A. Groskaufmanis, *The Supreme Court Has Upheld the Misappropriation Theory, But How Far the SEC Will Take the Ruling Is Anything But Clear*, NAT'L L.J., Aug. 4, 1997, at B4 ("*O'Hagan* undermines the SEC's possession theory of liability, . . . stress[ing] that the test for insider trading liability is whether the person accused traded on the basis of material, nonpublic information.").

¹¹⁶ See *Smith*, 155 F.3d at 1067 (recognizing that the Supreme Court's language was merely dicta); *Adler*, 137 F.3d at 1334 ("We acknowledge that the Supreme Court's language in *Chiarella*, *Dirks*, and *O'Hagan* is dicta, because in those cases there was no question that the material nonpublic information was actually used in trading.").

¹¹⁷ See *O'Hagan*, 521 U.S. at 648 (explaining that *O'Hagan* "us[ed] for his own trading purposes material, nonpublic information regarding Grand Met's planned tender offer [of Pillsbury]"); *Dirks*, 463 U.S. at 648 (asserting that *Dirks* "disclosed [material, nonpublic] information to investors who relied on it in trading in the shares of the corporation"); *Chiarella v. United States*, 445 U.S. 222, 245 (1980) (Burger, C.J., dissenting) (referring to *Chiarella*'s testimony at trial that he "used that information [the names of companies that were to become the object of takeover bids] as a basis for purchasing stock" (internal quotations omitted)).

¹¹⁸ See 7 LOSS & SELIGMAN, *supra* note 39, at 3504-05 ("When there is no question that the inside information was actually used in trading—which is normally the case—it seems natural to speak in terms of not trading 'on' or 'on the basis of' the information without necessarily implying that possession alone would not suffice.").

¹¹⁹ There are several lower court decisions in which the court employs both "use" and "possession" language interchangeably. See 2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(620), at 7:160.12 ("A number of other decisions speak of use (or its equivalents) but also, and more or less interchangeably, of possession."); see also *United States v. Cusimano*, 123 F.3d 83, 87 (2d Cir. 1997) (explaining that "under [the traditional theory of insider trading] a corporate insider trades in the securities of his own corporation on the basis of material, non-public information," but that "under the misappropriation theory § 10(b) and Rule 10b-5 are violated whenever a person trades while in knowing possession of material, non-public information that has been gained in violation of a fiduciary duty to its source" (emphasis added)); *Fridrich v. Bradford*, 542 F.2d 307, 312, 314 (6th Cir. 1976) (noting that "the district court found that all [the defendants] had violated Rule 10b-5 by trading in . . . stock while in possession of material inside information," and later describing the issue before the court as "how far the courts are to extend the private civil right of action under Section 10(b) and Rule 10b-5 when the alleged violation is the unlawful use of inside information and the stock involved is

O'Hagan, the Court employed "use" language when referring to Rule 14e-3, even though that rule explicitly adopted a "possession" standard.¹²⁰ The Court asserted: "One violates Rule 14e-3(a) if he trades *on the basis of* material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired . . . from an insider of the offeror or issuer, or someone working on their behalf."¹²¹ It thus appears that the Court was not paying close attention to its employment of "use" and "possession" language.

When analyzing the language of the Supreme Court, one must also examine carefully the context of the Court's statements and the point the Court was attempting to make. For example, when the Supreme Court declared that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information,"¹²² the Court was referring to the notion that there is no fraud under section 10(b) and Rule 10b-5 absent a fiduciary duty to disclose information before trading.¹²³ The Court asserted that such a duty to disclose "arises from a specific relationship between two parties,"¹²⁴ such as a "relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."¹²⁵ Rather than making a distinction between "possession" and "use" as an element of an insider trading violation, the Court was instead addressing the issue of *who* could be liable for insider trading—to whom the duty to "abstain or disclose" applied.¹²⁶ And, explicitly rejecting the parity-of-information theory, the Court concluded that the "disclose or abstain" rule applies not to everyone who possesses (or uses) material,

traded upon an impersonal market" (emphasis added)); *SEC v. Antar*, 15 F. Supp. 2d 477, 528, 529 (D.N.J. 1998) (noting that "§ 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation *on the basis of* material, nonpublic information," and later asserting that "the provisions discussed above [section 10(b) and Rule 10b-5] prohibit a person from selling securities *while in possession of* material, nonpublic information" (emphasis added) (citations omitted)).

¹²⁰ See *supra* note 58 and accompanying text (discussing Rule 14e-3 and observing that it provides for a "knowing possession" standard).

¹²¹ *O'Hagan*, 521 U.S. at 669 (emphasis added) (quoting *United States v. Chestman*, 947 F.2d 551, 557 (1991) (en banc)).

¹²² *Chiarella*, 445 U.S. at 235.

¹²³ See *id.* ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.").

¹²⁴ *Id.* at 233.

¹²⁵ *Id.* at 228.

¹²⁶ See 2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(620), at 7:160.11 ("[P]ossession is considered by the Court in reference to the creation of the disclose or abstain duty, not in juxtaposition to use as an element of violation.").

nonpublic information, but only to those with a pre-existing fiduciary duty to shareholders.¹²⁷

Similarly, in considering the Supreme Court's statements in *O'Hagan*, it is important to note that the Court's discussion took place in the context of the misappropriation theory.¹²⁸ In the context of the "possession versus use" debate, some commentators have drawn a distinction between the classical theory of insider trading and the misappropriation theory.¹²⁹ They argue that the misappropriation theory presupposes the use of inside information: underlying the theory is the notion that "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."¹³⁰ Under this theory, the "misappropriation" oc-

¹²⁷ See *Chiarella*, 445 U.S. at 231-33 (rejecting the parity-of-information theory). For a discussion of the parity-of-information theory, see *supra* note 29 and accompanying text.

¹²⁸ See *O'Hagan*, 521 U.S. at 649 (explaining that the Court was considering "the propriety of the misappropriation theory under § 10(b) and Rule 10b-5"). For a description of the misappropriation theory, see *supra* notes 18-20 and accompanying text.

¹²⁹ See, e.g., FERRARA ET AL., *supra* note 6, § 2.01[5], at 2-14.6 to 2-14.7 (suggesting that "the answer [to the 'possession versus use' debate] is best viewed as a function of a number of specific factors, including: whether the case is brought under the misappropriation theory or the classical theory of insider trading liability"); Horwich, *supra* note 5, at 1237-38 ("In order to focus the analysis of whether there is a distinction between (i) affirmatively using material inside information to trade, and (ii) trading while in possession of material inside information but without making deliberate use of the information, the analysis [in] this Article is limited to the classical theory."); see also *supra* Part I.A (discussing the classical theory of insider trading and the misappropriation theory). But see *infra* note 133 (arguing that if one accepts the "equal-access" theory, there is no reason to distinguish between the classical theory and the misappropriation theory for purposes of the "possession versus use" debate).

¹³⁰ *O'Hagan*, 521 U.S. at 652. The view that the misappropriation theory presupposes use, however, is not universally held. See *United States v. Cusimano*, 123 F.3d 83, 87 (2d Cir. 1997) (asserting that "under the misappropriation theory § 10(b) and Rule 10b-5 are violated whenever a person trades while in knowing possession of material, nonpublic information that has been gained in violation of a fiduciary duty to its source" (emphasis added)); LANGEVOORT, *supra* note 4, § 6.05[3], at 6-32 (referring to the misappropriation theory and describing the prohibited conduct as "trading while in possession" of inside information); *id.* at 6-32 n.16 ("Actually, an open question is whether the misappropriation theory requires motivation or mere possession."). Indeed, *Teicher*, the case in which the Second Circuit explicitly endorsed the "knowing possession" standard, involved the misappropriation theory. See *United States v. Teicher*, 987 F.2d 112, 119 (2d Cir. 1993) (discussing the misappropriation theory and its application to the case). The Supreme Court may have employed "use" language in *O'Hagan* merely because it was clear that the defendant had in fact used the inside information. See *supra* notes 117-19 and accompanying text (arguing that because the defendant used the information, it was natural for the Court to employ "use" language); see also 3 BROMBERG & LOWENFELS, *supra* note 6, § 7.5(517)(3), at 7:242.27 to

curs when the fiduciary uses the information without the principal's knowledge or permission.¹³¹ Even if the Court was consciously and purposefully employing "use" language in *O'Hagan*,¹³² such language is closely linked with its discussion of the misappropriation theory and should not be read as implicating the "possession" standard under the classical theory.¹³³

7:242.28 (2d ed. 1998) (explaining that "the government presented the [*O'Hagan*] case in 'use' terms, probably preferring not to complicate the misappropriation issue," and suggesting that one should not attach too much weight to the Court's choice of language).

¹³¹ See *O'Hagan*, 521 U.S. at 656 ("[T]he fiduciary's fraud is consummated . . . when, without disclosure to his principal, he uses the information to purchase or sell securities."); Phyllis Diamond, *McLucas Hails O'Hagan Ruling, But Says Issues over Reach of Theory Remain*, 29 SEC. REG. & L. REP. 1097, 1098 (1997) (quoting SEC Enforcement Director William McLucas, who explained that "the impropriety involved when someone like Mr. O'Hagan is a defendant is not getting the information" and that the misappropriation takes place when the defendant "uses [the information] to trade"); see also Horwich, *supra* note 5, at 1238 n.13 ("While it is easy to pose examples of an insider possessing nonpublic information but arguably not using it in making a trading decision, it is much more difficult to envision a plausible situation where someone first misappropriates information (an affirmative wrongful act) and then trades *without* using it").

¹³² See *supra* note 119 and accompanying text (asserting that because the "possession versus use" issue was not before the Supreme Court, the Court may not have paid close attention to its choice of "possession" or "use" language).

¹³³ See FERRARA ET AL., *supra* note 6, § 2.01[5], at 2-14.7 to 2-14.8 (suggesting that the *O'Hagan* Court's use of the phrase "on the basis of" is intertwined with its analysis of the misappropriation theory and arguing that under the classical theory of insider trading the "knowing possession" standard may still be "the better test"); Diamond, *supra* note 131, at 1098 (asserting that despite the Court's "use" language in *O'Hagan*, "certainly with respect to traditional insiders and certainly in the conventional analysis of tippee liability, we would argue that the standard remains . . . 'in possession of'").

Under the Supreme Court's conceptualization of the misappropriation theory in *O'Hagan*, the misappropriation involves the taking or use of inside information without the consent of the source of the information. The duty to disclose is owed only to the source of the information, and no violation of § 10(b) or Rule 10b-5 occurs if the fiduciary discloses to the source that he plans to trade on the information. See *O'Hagan*, 521 U.S. at 654-55 & n.6 (noting that the "disclosure obligation runs to the source of the information" and asserting that "if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no . . . § 10(b) violation"). In this sense, the misappropriation theory is quite distinct from the classical theory, and it is on this basis that many have removed the misappropriation theory from the "possession versus use" debate. See *supra* note 129 and accompanying text (explaining that some commentators have distinguished the classical theory from the misappropriation theory in the context of the "possession versus use" debate).

If, however, one accepts the equal-access theory, one must disclose information before trading if such information is not legally accessible to others. See *supra* note 29 and accompanying text (discussing the "equality of access to information" or "equal access" theory). This theory applies to insiders and outsiders alike, see *supra* notes 16-17 and accompanying text (defining "outsider trading"), effectively unifying the classi-

Proponents of the "use" standard have relied heavily on the "use" language employed in many of the Supreme Court cases addressing insider trading. Such reliance, however, is misplaced. In each of those cases, a causal connection clearly existed between the insider's trades and the inside information. Because the defendants had in fact used the information, it was natural for the Court to employ "use" language. Advocates of the "use" standard have recognized that "possession versus use" was not at issue in these cases and thus that the Supreme Court's adoption of "use" language is merely dicta. These advocates, however, have failed to recognize that the Court's choice of language in the cases is unreliable because the Court was not careful about distinguishing between "possession" and "use."

B. *Scienter and the Emphasis on Fraud*

Advocates of the "use" standard have also found support for their position in the Supreme Court's emphasis on fraud in its discussions of section 10(b) and Rule 10b-5 and in the scienter requirement. Liability cannot attach under section 10(b) and Rule 10b-5 unless it is shown that the defendant acted with scienter.¹³⁴ Although the courts have not clearly defined the term—particularly in the context of insider trading—the Supreme Court has asserted that scienter "refers to a mental state embracing intent to deceive, manipulate, or defraud."¹³⁵

cal and misappropriation theories. Because there are no longer relevant distinctions between the classical and misappropriation theories under this approach, arguments regarding the "possession" or "use" standard would apply equally to both theories. This Comment argues that the "possession" standard is the most appropriate rule, *see infra* Part IV, and further recommends that the "possession" standard be applied in insider trading cases under both the classical theory and the misappropriation theory. This is essentially the approach embodied in Rule 14e-3 pertaining to trading in the context of tender offers. *See supra* note 58 and accompanying text (discussing Rule 14e-3). There seems to be no reason, however, to limit such an approach only to tender offers, and this approach should be expanded to the more general cases of insider trading.

¹³⁴ *See* LANGEVOORT, *supra* note 4, § 3.04, at 3-22 ("Section 10(b) and Rule 10b-5 require a showing of scienter on the part of the defendant in order for liability to attach.").

¹³⁵ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976); *see also* LANGEVOORT, *supra* note 4, § 3.04, at 3-22 (asserting that "the courts have never offered a clear definition of scienter" and citing the Court's formulation of the term in *Hochfelder*). As one commentator has observed:

Inherently an elusive concept, scienter suffers particular problems in insider trading. It has to fit many different versions of the violation, some of them quite peculiar. Some of the standard articulations aren't well suited to insider trading. And, perhaps as a result, courts struggling to find words that make sense in factual contexts use multiple expressions which are not always consis-

Some advocates of the "use" standard have argued that a showing of scienter requires a showing that the defendant actually used the inside information in consummating his trade.¹³⁶ These arguments, however, are based on an improper interpretation of the scienter requirement in the context of insider trading.

In *Adler*, for example, the Eleventh Circuit argued that the defendant's motivation for trading—namely, whether or not he traded on the basis of inside information—was relevant to the issue of scienter.¹³⁷ The *Adler* court based its argument on a footnote from *Dirks*, in which the Supreme Court asserted:

[M]otivation is not irrelevant to the issue of scienter. It is not enough that an insider's conduct results in harm to investors; rather, a violation may be found only where there is "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."¹³⁸

Similarly, in *Smith*, the Ninth Circuit argued that the scienter requirement supports a "use" standard, contending that "an investor who has a preexisting plan to trade, and who carries through with that plan after coming into possession of material nonpublic information, does not intend to defraud or deceive."¹³⁹ Again, these arguments are based on an improper interpretation of the scienter requirement in the context of insider trading.

Under the common law concept of fraud, a defendant is said to

tent . . . Moreover, scienter is described in very different terms, sometimes in the same court opinion.

2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(810), at 7:163.

Nor is the term scienter defined in the federal securities laws. See *id.* § 7.4(800), at 7:162 ("[Scienter] appears nowhere in the 1933 or 1934 Securities Acts or their rules.").

¹³⁶ See, e.g., 2 BROMBERG & LOWENFELS, *supra* note 6, § 7.4(620), at 7:160.12 ("Even if use is not specified as an element of the violation, it may be construed as a component of another required element: scienter."); Horwich, *supra* note 5, at 1248 (noting that some "cases have addressed the possession versus use issue ostensibly in the context of whether scienter had been proven"). Other commentators have recognized a link between the scienter requirement and the "possession versus use" debate, although they have stopped short of asserting that the scienter requirement necessitates the adoption of the "use" standard. See, e.g., FERRARA ET AL., *supra* note 6, § 2.01[5], at 2-12 ("Another important issue in insider trading cases, inextricably linked to Section 10(b)'s and Rule 10b-5's requirement of scienter, involves what is often termed the 'possession vs. use' debate.").

¹³⁷ *Adler*, 137 F.3d at 1334 (noting that "the majority and the dissent in *Dirks* disagreed about whether motivation is relevant to proving scienter as an element of an insider trading violation").

¹³⁸ *Dirks*, 463 U.S. at 663 n.23 (quoting *Hochfelder*, 425 U.S. at 199).

¹³⁹ *Smith*, 155 F.3d at 1068.

act with scienter if he misstates a material fact, knowing that the statement is false and intending that the recipient of such information rely on it.¹⁴⁰ In the context of insider trading, the scienter requirement has been interpreted to mean that the defendant must have had actual knowledge of material, nonpublic information and also must have known that the information was both material and nonpublic.¹⁴¹ The reason for the defendant's actions is largely irrelevant, provided he acted knowingly.¹⁴²

Indeed, in interpreting the scienter requirement, one must distinguish between "the lack of good faith required for scienter" and "bad motive,"¹⁴³ which is not required. Although scienter requires intent, it does not require intent "in the sense of intent to harm or do evil"; rather, the intent required by scienter is "the intent to commit the fraud itself."¹⁴⁴ As William H. Kuehnle has explained, "the gravamen of the moral deficiency in fraud is not that the defendant was try-

¹⁴⁰ See LOSS & SELIGMAN, *supra* note 21, at 751 (explaining that "the defendant must know of the falsity [of his statement] (this kind of knowledge is called 'scienter'), but make the statement nevertheless for the purpose of inducing the plaintiff to rely on it").

¹⁴¹ See SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983) (explaining that "the [scienter] requirement is satisfied if at the time defendant purchased stock he had actual knowledge of undisclosed material information; knew it was undisclosed, and knew it was material"); see also ROBERT CHARLES CLARK, CORPORATE LAW § 8.10.3, at 328 (1986) ("The point of [*Hochfelder*] in this context would seem to be only that the defendant must have known that the information to which he had access while trading was material and nonpublic.").

In *Hochfelder*, the Supreme Court expressly reserved the question of whether recklessness could constitute scienter, see *Hochfelder*, 425 U.S. at 194 n.12 ("In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5."), and "[v]irtually all lower courts addressing this issue since *Hochfelder* have concluded that a rule 10b-5 violation may be grounded on 'recklessness' . . . and that knowing, intentional misconduct is not a necessary ingredient of establishing liability." ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 935 (5th ed. 1994).

¹⁴² As Langevoort notes: "The law of fraud on which this [duty to disclose or abstain] is based is a clear-cut disclosure duty for the benefit of the protected party, not limited to situations where it is shown that the fiduciary was trying to take advantage of the information." LANGEVOORT, *supra* note 4, § 3.04, at 3-26; see also RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977) ("One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them . . .").

¹⁴³ William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121, 195 (1997).

¹⁴⁴ *Id.*

ing to harm the victim, but rather that the defendant was willing to mislead the victim."¹⁴⁵ If, for example, an insider knowingly made false statements to an investor about the corporation's stock, he would be guilty of fraud—regardless of his motives for making such misrepresentations.¹⁴⁶ Analogizing to the context of insider trading, a defendant who knowingly trades while in possession of material, nonpublic information acts with the requisite scienter, regardless of his motives for trading. As the SEC argued in *Smith*, the "requisite intent to defraud is inherent in the act of trading while in possession of inside information."¹⁴⁷ The *Adler* and *Smith* courts fail to make this distinction between "intent to harm" and "intent to commit fraud" when they assert that a defendant does not act with the requisite scienter if he has an "innocent" reason for trading.

Much of the confusion surrounding the scienter requirement may be attributed to the frequent establishment of scienter through the use of circumstantial evidence.¹⁴⁸ In reading cases that have discussed the scienter requirement, courts and commentators have confused the reliance on use of information to prove scienter with a requirement that use of information be proved in order to satisfy the scienter element. In some cases, there may not be direct evidence that the defendant had knowledge of (knowingly possessed) the inside information or that the defendant knew such information was material. In such cases, courts may rely on "suspicious" trading as evidence that the defendant actually knew the information, or the court may rely on evidence that the defendant used inside information to prove that the defendant knew such information was material. In these cases, evidence of the defendant's *use* of information is not independently important; rather, it is relevant merely as a means of establishing that the

¹⁴⁵ *Id.*

¹⁴⁶ See *id.* (discussing a similar hypothetical and citing RESTATEMENT (SECOND) OF TORTS § 526 (1977) as support); see also LOSS & SELIGMAN, *supra* note 21, at 842 n.314 (citing *W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS* 741 (W. Page Keeton ed., 5th ed. 1984) and asserting that "the intent to deceive or mislead or convey a false impression that is implicit in the scienter concept goes simply to the matter of belief, or absence of belief, that the representation is true").

¹⁴⁷ *Smith*, 155 F.3d at 1068.

¹⁴⁸ See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 n.30 (1983) (noting that "proof of scienter required in fraud cases is often a matter of inference from circumstantial evidence"); see also LANGEVOORT, *supra* note 4, § 3.04, at 3-22 n.2 ("Scienter can, of course, be established by circumstantial evidence."); LOSS & SELIGMAN, *supra* note 21, at 837 ("[I]ntent (or scienter) being subjective, it must often 'be inferred from a series of seemingly isolated acts and instances which have been . . . aptly designated as badges of fraud.'" (quoting *Nassan v. United States*, 126 F.2d 613, 615 (4th Cir. 1942))).

defendant possessed the information and knew that the information was material. In *SEC v. MacDonald*, for example, the defendant appealed the trial court's finding of scienter, asserting that the SEC had failed to establish that he knew the inside information was material.¹⁴⁹ The court, however, found that the "inside information was a motivating factor in [the defendant's] purchase of . . . stock"¹⁵⁰ and concluded that such use of the information was evidence that the defendant considered the information to be material.¹⁵¹

On the other hand, where there is little or no evidence that the defendants actually possessed material, nonpublic information, the court may rely on evidence of legitimate or innocent reasons for trading to conclude that the defendant did not act with the requisite scienter.¹⁵² In *In re Worlds of Wonder Securities Litigation*, for example, the plaintiffs alleged that the defendants, insiders who sold some of their shares prior to the company's bankruptcy, violated the insider trading prohibitions.¹⁵³ The plaintiffs tried to use evidence of the defendants' trading as evidence that the defendants had access to material, nonpublic information.¹⁵⁴ But, observing that the defendants sold only a small percentage of their holdings and suffered large losses when the

¹⁴⁹ *MacDonald*, 699 F.2d at 50 ("Defendant does not contest . . . the court's finding that he had knowledge of the facts found to be material, and knew such facts to be undisclosed. He does claim, however, that the SEC failed to establish . . . the necessary third element, knowledge of materiality . . .").

¹⁵⁰ *Id.* at 51.

¹⁵¹ *See id.* ("Obviously, if defendant himself considered the information important in deciding whether to purchase, he knew a reasonable investor would likewise consider it important in deciding whether to sell.").

¹⁵² As Langevoort explains:

In many cases, a defendant argues factually that he was not in possession . . . of any inside information when he traded. The SEC . . . has only circumstantial evidence of possession. In this setting, many courts have wisely taken the position that the timing of the trade (e.g., shortly after a telephone conversation with someone who clearly knew the information and had some reason to pass it on) suffices to create an inference of insider trading, but only if such a trade was inconsistent with the defendant's prior pattern of trading activity. As such, if the defendant had some predetermined plan of selling, or was buying or selling only in normal amounts, it would rebut any inference of . . . possession

LANGEVOORT, *supra* note 4, § 3.04, at 3-25.

¹⁵³ 35 F.3d 1407, 1427 (9th Cir. 1994) (discussing the plaintiffs' allegations that the defendants traded "with knowledge of undisclosed adverse, material information").

¹⁵⁴ *See id.* ("Plaintiffs assert that since these defendants sold some of their shares . . . prior to [the company's] financial collapse, they must have known of some information, not already known to the market, that signalled [the company's] imminent doom." (quoting *In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 871 (N.D. Cal. 1993) [hereinafter *Worlds of Wonder II*])).

company went bankrupt, the court suggested that the trades did not seem suspicious and asserted that one could not reasonably conclude from such trades alone that the defendants *possessed* inside information.¹⁵⁵ Because there was no other evidence that the defendants possessed nonpublic information, the court thus concluded that the defendants lacked scienter.¹⁵⁶

In reading cases such as *MacDonald* and *Worlds of Wonder*, courts and commentators have confused the reliance on use of information to prove scienter with a requirement that use of information be proved in order to satisfy the scienter element. Indeed, the *Adler* court cited *Worlds of Wonder* in support of the "use" standard, asserting that "[i]n a number of cases, courts have allowed insiders to introduce evidence of preexisting plans or other 'innocuous' reasons for sales in order to rebut an inference of scienter."¹⁵⁷ In particular, the *Adler* court pointed to the statement in *Worlds of Wonder* that "[e]ven if the evidence was sufficient to permit an inference that one or more of the defendants had access to inside information, the defendants' actual trading would conclusively rebut an inference of scienter."¹⁵⁸ The *Adler* court further observed that in *Worlds of Wonder*, "the court emphasized that some of the insiders 'sold their shares pursuant to a predetermined plan,' one insider sold 'because it faced a pressing need to service a huge debt incurred from overinvesting in real estate,' and another insider only sold a small percentage of his shares."¹⁵⁹ The *Adler* court therefore concluded that scienter requires use—not mere possession—of inside information.¹⁶⁰ But in interpreting *Worlds of Wonder*, it is important to recall that there was no evidence that the defendants actually *possessed* any inside information.¹⁶¹ The court was not

¹⁵⁵ See *id.* (asserting that "when one considers the amounts traded, Plaintiffs' claims appear fantastic" and concluding that "no reasonable jury could find that insider trading had occurred" (quoting *Worlds of Wonder II*, 814 F. Supp. at 872)).

¹⁵⁶ See *id.* (explaining that the "[p]laintiffs cannot point to any bit of information traded on by these defendants that was not already known to the market" and concluding that "no reasonable jury could find . . . that these defendants acted with scienter" (quoting *Worlds of Wonder II*, 814 F. Supp. at 872)).

¹⁵⁷ *Adler*, 137 F.3d at 1335.

¹⁵⁸ *Id.* (quoting *Worlds of Wonder*, 35 F.3d at 1427-28).

¹⁵⁹ *Id.* (citing *Worlds of Wonder*, 35 F.3d at 1427-28).

¹⁶⁰ See *id.* (asserting that cases such as *Worlds of Wonder* "provide support for the proposition that there is no violation of § 10(b) and Rule 10b-5 in the absence of some causal connection between the material nonpublic information and an insider's trading").

¹⁶¹ See *supra* note 156 and accompanying text (discussing the lack of evidence that defendants possessed nonpublic information).

suggesting that use of information is a requirement for scienter. Rather, the defendants' preexisting trading plans were relevant only as far as they provided evidence that the defendants did not possess inside information.¹⁶² Indeed, if there had in fact been independent proof that the defendants possessed material, nonpublic information, the court likely would have found scienter. The *Adler* court's conclusion that the scienter requirement mandates a "use" standard is thus based on an improper interpretation of scienter and the manner in which it is often established in the context of insider trading.¹⁶³

The *Adler* court found further support for its assertion that a defendant's motivation for trading is relevant in the Supreme Court's holding that a tipper must personally benefit from his tip to be liable for insider trading.¹⁶⁴ The *Adler* court, however, seems to have taken the Supreme Court's holding out of context. In asserting that an insider must benefit from his tip, the Supreme Court observed that not all disclosures of confidential information constitute a breach of fiduciary duty.¹⁶⁵ The Supreme Court noted that an insider who conveys such information may not know that the information is confidential—he may mistakenly believe that the information has already been publicly disclosed—or the insider may not believe that such information is material.¹⁶⁶ The requirement of a benefit, then, seems merely to be a means of ensuring that the tipper-defendant knew the information was material and nonpublic.¹⁶⁷

Citing the *O'Hagan* opinion, the *Adler* court also claimed the sup-

¹⁶² See LANGEVOORT, *supra* note 4, § 3.04, at 3-25 n.11 (discussing *Worlds of Wonder* and the inappropriateness of interpreting that case as favoring the use standard).

¹⁶³ See *id.* at 3-26 n.11 ("Citation to these sorts of cases as authority in favor of a use standard . . . is plainly inappropriate."); *id.* at 3-25 to 3-26 ("These cases . . . have no bearing whatsoever on choosing between the two standards [possession or use]—a point that the courts in *Adler* and *Smith* unfortunately missed when they cited them in support of the use test.").

¹⁶⁴ *Adler*, 137 F.3d at 1334 ("[T]he *Dirks* Court's holding that [a] tipper must gain some personal advantage in order for [a] tippee to be liable for trading on material nonpublic information, suggests that knowing possession of material nonpublic information at the time of trading may not be enough to establish liability for insider trading."); see also *Dirks v. SEC*, 463 U.S. 646, 661-62 (1983) (asserting that the insider must benefit from his tip for there to be a breach of fiduciary duty and insider trading liability).

¹⁶⁵ See *Dirks*, 463 U.S. at 661-62 ("All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders.").

¹⁶⁶ See *id.* at 662 ("Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market.").

¹⁶⁷ See LANGEVOORT, *supra* note 4, § 3.04, at 3-26 n.13 (asserting that one cannot look to *Dirks*'s requirement of a benefit to resolve the "possession versus use" debate).

port of the Supreme Court for the proposition that the "knowing possession test may prohibit actions that are not themselves fraudulent."¹⁶⁸ In particular, the *Adler* court noted the following assertion from *O'Hagan*: "under § 14(e), the Commission may prohibit acts, not themselves fraudulent under the common law or § 10(b), if the prohibition is 'reasonably designed to prevent... acts and practices [that] are fraudulent.'"¹⁶⁹ But the *Adler* court misinterpreted the Supreme Court's discussion, taking statements it made about section 14(e) and Rule 14e-3 out of their original context. In *O'Hagan*, the Supreme Court was addressing the defendant's contention that the SEC had exceeded its rulemaking authority under § 14(e) when it adopted Rule 14e-3(a).¹⁷⁰ Although it is true that Rule 14e-3 adopted a "knowing possession standard,"¹⁷¹ this aspect of the rule was not under attack. Rather, *O'Hagan* contested the validity of Rule 14e-3(a) because it imposes a duty to "disclose or abstain" regardless of whether the trader has a preexisting fiduciary duty to either the shareholders or the source of the information.¹⁷² As the Supreme Court asserted in *Chiarella*, there is no fraud absent a fiduciary duty to disclose information before trading.¹⁷³ Because Rule 14e-3 imposes liability even where there is no such fiduciary duty, effectively prohibiting conduct which is not fraudulent under *Chiarella*, the defendant in *O'Hagan* argued that the SEC had exceeded its rulemaking authority to define fraud under section 14(e). The Supreme Court did not resolve whether the SEC exceeded its section 14(e) power to define fraud. Instead, the Court noted that section 14(e) also gave the SEC

¹⁶⁸ *Adler*, 137 F.3d at 1338 (citing *O'Hagan*, 521 U.S. at 673).

¹⁶⁹ *Id.* (citing *O'Hagan*, 521 U.S. at 673).

¹⁷⁰ *O'Hagan*, 521 U.S. at 666-67 (considering whether "the Commission... exceed[ed] its rulemaking authority under § 14(e) when it adopted Rule 14e-3(a) without requiring a showing that the trading at issue entailed a breach of fiduciary duty"). Section 14(e) gave the SEC authority to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 78n(e) (1997).

¹⁷¹ See *supra* note 58 (discussing Rule 14e-3).

¹⁷² See *O'Hagan*, 521 U.S. at 669 (explaining that "[i]n the Eighth Circuit's view, [and presumably in the defendant's view,] because Rule 14e-3(a) applies whether or not the trading in question breaches a fiduciary duty, the regulation exceeds the SEC's § 14(e) rulemaking authority"). The "possession" standard suggested for section 10(b) and Rule 10b-5 liability does not eliminate the requirement of a fiduciary duty required under both the classical theory and the misappropriation theory. See *supra* Part I.A (discussing the two theories of insider trading liability).

¹⁷³ *Chiarella*, 445 U.S. at 235 ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."); see also *supra* notes 122-27 (discussing *Chiarella* and the fiduciary duty requirement).

"prophylactic" authority to prevent fraud,¹⁷⁴ and concluded that Rule 14e-3(a) "qualifies under § 14(e) as a 'means reasonably designed to prevent' fraudulent trading on material, nonpublic information in the tender offer context."¹⁷⁵ It was only in this context that the Supreme Court held that under section 14(e) the SEC may prohibit actions that are not fraudulent. When considered in the proper context, the Supreme Court's assertion does not support the *Adler* court's conclusion that the "knowing possession" standard prohibits conduct that is not fraudulent.

Indeed, examined in the proper context, statements by the Supreme Court lend little support to the arguments in favor of the "use" standard; many of the statements relied upon by advocates of the "use" standard have been misinterpreted and taken out of their original context. Although reliance on Supreme Court precedent and other insider trading case law in support of the "use" standard thus appears unwarranted, nothing in the preceding discussion suggests that "knowing possession" is the correct standard.¹⁷⁶ The next Part sets forth the reasons for adopting a "possession" standard.

IV. ARGUMENTS SUPPORTING THE "KNOWING POSSESSION" STANDARD

There are two primary reasons for adopting the "possession" standard and imposing insider trading liability for trading while in possession of material, nonpublic information. The first relates to the difficulty of proving actual use. The second relates to the rationale underlying the insider trading prohibition—the concern that inves-

¹⁷⁴ See *O'Hagan*, 521 U.S. at 673 (citing *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 11 n.11 (1985), in which the Court asserted that "§ 14(e)'s rulemaking authorization gives the Commission 'latitude,' . . . 'to regulate nondeceptive activities as a "reasonably designed" means of preventing manipulative acts, without suggesting any change in the meaning of the term "manipulative" itself'").

¹⁷⁵ *Id.* at 672. Note, however, that the SEC seems to have been exercising its fraud-defining authority, rather than its prophylactic authority in Rule 14e-3(a), see 17 C.F.R. § 240.14e-3(a) (1999) (providing that the activity described "shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the Act"), although the SEC apparently believed it was exercising its prophylactic power in Rule 14e-3(d). See 17 C.F.R. § 240.14e-3(d) (prohibiting certain conduct "[a]s a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act").

¹⁷⁶ Indeed, because the "possession versus use" debate has not squarely been at issue in prior cases, one should not interpret the language in earlier case law as endorsing either the "possession" or the "use" standard. See *supra* Part III.A (discussing the inappropriateness of relying on "use" language in Supreme Court insider trading opinions for support of the "use" standard).

tors perceive the securities markets as fair and honest.¹⁷⁷

A. Difficulty of Establishing Actual Use

The SEC has advocated the "possession" standard largely because it believes that a "use" standard would make it unnecessarily difficult to prosecute insider trading.¹⁷⁸ Under a "use" test, the SEC (or the government), as well as private parties, not only would be required to establish that the defendant possessed material, nonpublic information, but also would "have to get into his mind" to determine whether the trade was based on such information.¹⁷⁹ As Director McLucas explained: "The problem with the 'on the basis of' standard is clear—it makes proof of a violation subject to metaphysical impossibility. . . . When a trader knows the material information, divining that he . . . acted 'on the basis of' as opposed to 'while in possession of' may be impossible."¹⁸⁰ With the "use" standard, the concern is that insider-traders will "contrive" legitimate reasons for their transactions, offering innocent explanations such as mortgage obligations and college tuition payments.¹⁸¹ As the SEC asserted: "Individuals who have actually traded on the basis of inside information frequently attempt to invent arguments that they have traded for other reasons. Under a 'possession' standard, such *post hoc* rationalizations would be irrelevant, and could not be used to impede enforcement of the law."¹⁸² The *Teicher* court also acknowledged this concern when it endorsed the "knowing possession" standard: "As a matter of policy then, a requirement of a causal connection between the information and the

¹⁷⁷ See *supra* Part I.B (discussing the reasons for the insider trading prohibition).

¹⁷⁸ See *House Hearings*, *supra* note 32, at 49 (statement of John M. Fedders, SEC Director of Enforcement) ("[T]he 'based on' [or 'use'] standard . . . would . . . mak[e] our prosecutorial efforts much more difficult."). The SEC's position, however, has not been consistent. See *supra* notes 49-54 and accompanying text (discussing the SEC's inconsistency in its interpretation of Rule 10b-5).

¹⁷⁹ *House Hearings*, *supra* note 32, at 49 (statement of John M. Fedders, SEC Director of Enforcement).

¹⁸⁰ McLucas & Angotti, *supra* note 34, at 5; see also Diamond, *supra* note 131, at 1098 (quoting McLucas's assertion that the government "cannot metaphysically get into someone's head and discern what factors within their state of mind were directly causal").

¹⁸¹ See Diamond, *supra* note 131, at 1098 (explaining that the SEC's concern is that "[t]here's not a defendant that comes in the door that won't have a separate, independent, superseding tort law factor for his buying or selling activity").

¹⁸² Proposed Language for Inclusion in Committee Report on Insider Trading Definition, 20 SEC. REG. & L. REP. (BNA) 279, 280 (1988).

trade could frustrate attempts to distinguish between legitimate trades and those conducted in connection with inside information."¹⁸³

B. *Perception That Markets are Honest and Fair*

The difficulty of establishing actual use of inside information is not the only reason for adopting a "possession" standard. Considered alone, such an explanation invites the inference that there is nothing wrong with mere possession of material, nonpublic information at the time of a trade, aside from the difficulty of proving actual use of such information. One might infer that the securities laws seek to prevent the use of inside information but, because of difficulties of proof, also prohibit trading while in possession of such information—even though the policy reasons underlying the insider trading prohibition do not really apply to mere possession. This inference is the one that many advocates of the "use" standard apparently have drawn in rejecting the SEC's rationale for the "possession" standard.¹⁸⁴ But the policy reasons underlying the insider trading prohibition do apply to trading while in possession of material, nonpublic information. Recognizing the difficulties of proof associated with a "use" test, the *Adler* court held that an "inference of use . . . arises from the fact that [an] insider traded while in knowing possession of material nonpublic information."¹⁸⁵ The problem with this approach, however, is its failure to recognize that the rationale for the insider trading prohibition applies

¹⁸³ *Teicher*, 987 F.2d at 121. Other commentators have also agreed with this argument. See, e.g., 7 LOSS & SELIGMAN, *supra* note 39, at 3505 ("The very difficulty of establishing actual use of inside information points to possession as the test.").

¹⁸⁴ See Horwich, *supra* note 5, at 1270 (explaining that "choosing the simpler rule is defensible only if it comports equally well with the underlying policy of the law as does the alternative, more complex rule," but that "that is not the case if actual use of the inside information is what underlies the rationale for the prohibition"). Horwich is implicitly assuming that the policy reasons for the insider trading prohibition do not apply to trading while in possession of material, nonpublic information, provided there is no causal connection between the trade and the information. See *id.* at 1271 (contending that the insider who trades merely while in possession of inside information is "innocent"). As a result, he does not believe that such trading should be prohibited merely because it may be difficult to distinguish between use and possession. See *id.* at 1270-71 ("The fact that the distinction may be difficult to draw in some cases does not mean that it cannot or should not be drawn wherever possible, so long as the underlying policy for the prohibition can be respected.").

¹⁸⁵ *Adler*, 137 F.3d at 1337; see also *id.* ("[W]hen an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading. The insider can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade . . .").

equally to both trading *on the basis of*, and trading *while in possession of*, inside information.¹⁸⁶

The basic rationale for the insider trading prohibition is the belief that insider trading undermines investors' expectations of honest and fair securities markets and that, as a result, insider trading will discourage investors from participating in the markets.¹⁸⁷ The argument is that investors view trading on the basis of material, nonpublic information as fundamentally unfair. The question, then, is whether investors would also question the fairness of markets in which investors routinely trade while in possession of material, nonpublic information—even if such traders claimed that there was no causal connection between such information and the decision to trade.

The answer to this question may be found in an observation by the *Teicher* court about the nature of information. The *Teicher* court observed: "Unlike a loaded weapon which may stand ready but unused, material information cannot lay idle in the human brain."¹⁸⁸ Even if an insider in possession of material, nonpublic information believes that his trades are motivated solely by legitimate reasons, it is unlikely that the information possessed by a trader would not in some way influence his trades. Investors are likely to believe that such information influenced—whether consciously or subconsciously—the insider's trades, despite the insider's assertions to the contrary. Investors are likely to believe, for example, that an insider with a pre-existing plan to sell shares to pay his daughter's college tuition, may decide to sell 110 shares upon coming into possession of the inside information, instead of the 100 shares he had previously planned to sell. Investors are therefore just as likely to doubt the fairness of markets in which participants trade *while in possession of* inside information as they are to doubt the fairness of markets in which participants trade *on the basis of* inside information. It is for this reason that "knowing possession" should be sufficient for insider trading liability.¹⁸⁹

¹⁸⁶ As the *Smith* court noted, another problem with this approach is that such a presumption of use cannot be applied in the criminal context. *United States v. Smith*, 155 F.3d 1051, 1069 (9th Cir. 1998) (asserting that in the context of a criminal prosecution, "[w]e are . . . not at liberty, as was the *Adler* court, to establish an evidentiary presumption that gives rise to an inference of use"). On the other hand, there is no reason why the standards for criminal and civil liability cannot be different; courts could employ a "use" standard in the criminal context and a "use by presumption" standard in the civil context.

¹⁸⁷ See *supra* Part I.B (discussing the reasons for the insider trading prohibition).

¹⁸⁸ *Teicher*, 987 F.2d at 120.

¹⁸⁹ Note that this reasoning applies whether liability is predicated upon the classical theory or the misappropriation theory of insider trading. Investors are just as likely to

Advocates of the use standard suggest that there is nothing inherently unfair about trading merely while in possession of material, nonpublic information, since such trading involves no exploitation or abuse of inside information.¹⁹⁰ That may be true, but, as discussed above, investors are likely to *perceive* such trading as unfair, believing that a trader possessing inside information cannot escape the influence of such information. And to the extent that the insider trading prohibition is based on the belief that investors will not participate in a market that they perceive to be unfair, it is investors' *perceptions* that are relevant in determining what conduct should be prohibited.

Some proponents of the "use" standard further suggest that it is unfair to penalize and prevent from trading¹⁹¹ the insider who engages in a regular and periodic program of selling to liquidate his holdings in the corporation's stock and obtain needed cash.¹⁹² For the insider who, because of cash requirements, must sell regularly and cannot always wait until the information is publicly disclosed, the "possession" test may seem particularly burdensome and unfair.¹⁹³ But it need not

doubt the fairness of the markets if the trader is a corporate insider trading in the securities of his corporation while in possession of inside information as they are if the trader is an "outsider" such as O'Hagan, *see supra* notes 16-19 and accompanying text (discussing "outsider trading" and the *O'Hagan* case), trading in another corporation's securities while in possession of material, nonpublic information obtained from an outside (confidential) source. The "knowing possession" standard should therefore be applied in insider trading cases under both the classical theory and the misappropriation theory of insider trading liability. This conclusion clearly follows if one accepts the concept of equality of access to information (or the "equal-access" theory). *See supra* notes 29, 133 and accompanying text (discussing the equal-access theory and its implications for the classical theory and misappropriation theory in the context of the "possession versus use" debate). The Supreme Court, however, has rejected the equal-access theory, *see supra* note 29, and, as a result, courts and commentators may continue to distinguish between the classical theory and the misappropriation theory in the context of the "possession versus use" debate. *See supra* note 129 and accompanying text (explaining that some commentators have distinguished the classical theory from the misappropriation theory for purposes of the "possession versus use" debate).

¹⁹⁰ *See* Horwich, *supra* note 5, at 1270-76 (using various hypotheticals to suggest the unfairness of imposing insider trading liability "when the decision to trade was made without any exploitation of material nonpublic information").

¹⁹¹ Since the insider has the choice of disclosing the information or abstaining from trading, the insider is prevented from trading only to the extent that he cannot disclose the information. Often, however, insiders do not have the authority to disclose the information. *See id.* at 1271 n.230 ("[F]ew individual insiders have the discretion or right to choose to disclose confidential material information about their employer.").

¹⁹² *See id.* at 1273 (discussing the case of an executive with a regular, consistent purchase or sale program).

¹⁹³ The situation is a bit different where the insider wishes to buy, rather than sell, stock. Here, there is not the same necessity for engaging in the trade—the insider has

be. Such an insider could, for example, maintain his stock portfolio with an investment advisor who has complete discretion over the nature and timing of transactions.¹⁹⁴ The investment advisor could then execute whatever trades are necessary to provide the insider with the cash he requires.¹⁹⁵ The "knowing possession" standard thus goes further than the "use" standard in ensuring the integrity of the markets, without unnecessarily burdening insiders who wish to trade.

The *Smith* court, however, was concerned that a "knowing-possession standard would . . . go a long way toward making insider trading a strict liability crime."¹⁹⁶ Given the statutorily authorized ten-year prison sentence for insider trading convictions, the court was reluctant to adopt such a standard.¹⁹⁷ But the *Smith* court's concern was unnecessary. The "possession" standard does not make insider trading a strict liability crime. First, the scienter requirement ensures that the defendant knowingly (or at least recklessly) possessed inside information and that he knew such information was material.¹⁹⁸ Second, as the Supreme Court noted in *O'Hagan*, a defendant may not be im-

more "flexibility" to delay his purchases until the information is disclosed to the public. Of course, delaying purchases until disclosure may mean that the insider is purchasing at a higher price. Nonetheless, this situation does not seem unnecessarily unfair to the insider. Delaying the insider's purchases seems to be a reasonable price to pay for ensuring the integrity of the market. Indeed, as between the ordinary investor and the insider, it is the insider who is best able to bear the risk that the insider will come into possession of inside information when he seeks to trade. See *id.* at 1271 (recognizing this as a counterargument to the contention that the "possession" standard is unfair).

¹⁹⁴ See Alan M. Weinberger, *Preventing Insider Trading Violations: A Survey of Corporate Compliance Programs*, 18 SEC. REG. L.J. 180, 188 (1990) (explaining that the New York Stock Exchange recommends, among other things, that insiders engage in trading activities through regular investment programs in which the timing of trades is beyond the control of the insider); see also Steinberg & Fletcher, *supra* note 38, at 1820 (noting that many broker-dealer and investment firms require employees to maintain all of their trading accounts with the firm). Of course, one could still argue that this is unfair, since the insider must give up discretion over his own accounts. As between the ordinary investor and the insider, however, the insider is in the better position to bear the "costs" of inside information. See *supra* note 193 (making this argument).

¹⁹⁵ Such an insider could argue credibly that he did not trade, since it was his investment advisor that made the decision to trade and executed the trade.

¹⁹⁶ *Smith*, 155 F.3d at 1068 n.25.

¹⁹⁷ See *id.* ("In view of the statutorily authorized ten-year prison sentence that may accompany an insider trading conviction, any construction of Rule 10b-5 that de facto eliminates the mens rea requirement should be disfavored." (citations omitted)); see also 15 U.S.C. § 78ff(a) (1994) (authorizing a ten-year prison sentence).

¹⁹⁸ See *supra* notes 134, 140-41 and accompanying text (discussing the scienter requirement); see also *United States v. O'Hagan*, 521 U.S. 642, 665 (1997) (explaining that under 15 U.S.C. § 78ff(a), "[t]o establish a criminal violation of Rule 10b-5, the Government must prove that a person 'willfully' violated the provision").

prisoned for violating Rule 10b-5 if he proves that he had no knowledge of the rule.¹⁹⁹

Both the rationale underlying the insider trading prohibition, as well as the difficulty of proving an insider's motivation for trading, thus suggest that courts should adopt the "knowing possession" standard for determining insider trading liability under the federal securities laws.

CONCLUSION

Advocates of the "use" standard have looked primarily to prior case law, particularly Supreme Court precedent, for support of their position. The problem with this approach, however, is that the question of "possession versus use" was not at issue in the cases relied upon, and those opinions were not careful about making a distinction between "possession" and "use." Indeed, many of the statements relied upon by advocates of the "use" standard either are dicta or have been misinterpreted and taken out of their original context. Rather than relying on case law, then, one should look to the reasons for the insider trading prohibition, as well as to the difficulty of proof associated with prosecution, to determine the proper standard. Such an inquiry suggests that "possession" is the more appropriate standard for imposing insider trading liability. Nonetheless, with the recent opinions by the Ninth and Eleventh Circuits, the question of "possession versus use" seems well on its way to being resolved in favor of the "use" standard. Until the Supreme Court explicitly addresses the question, however, the issue will remain open for debate.

¹⁹⁹ See 15 U.S.C. § 78ff(a) ("[N]o person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."). Lack of knowledge of the law, however, is not a defense to the imposition of the statutorily authorized fines of up to \$1,000,000. See *O'Hagan*, 521 U.S. at 666 n.13 ("The statute provides no such defense to imposition of monetary fines.").